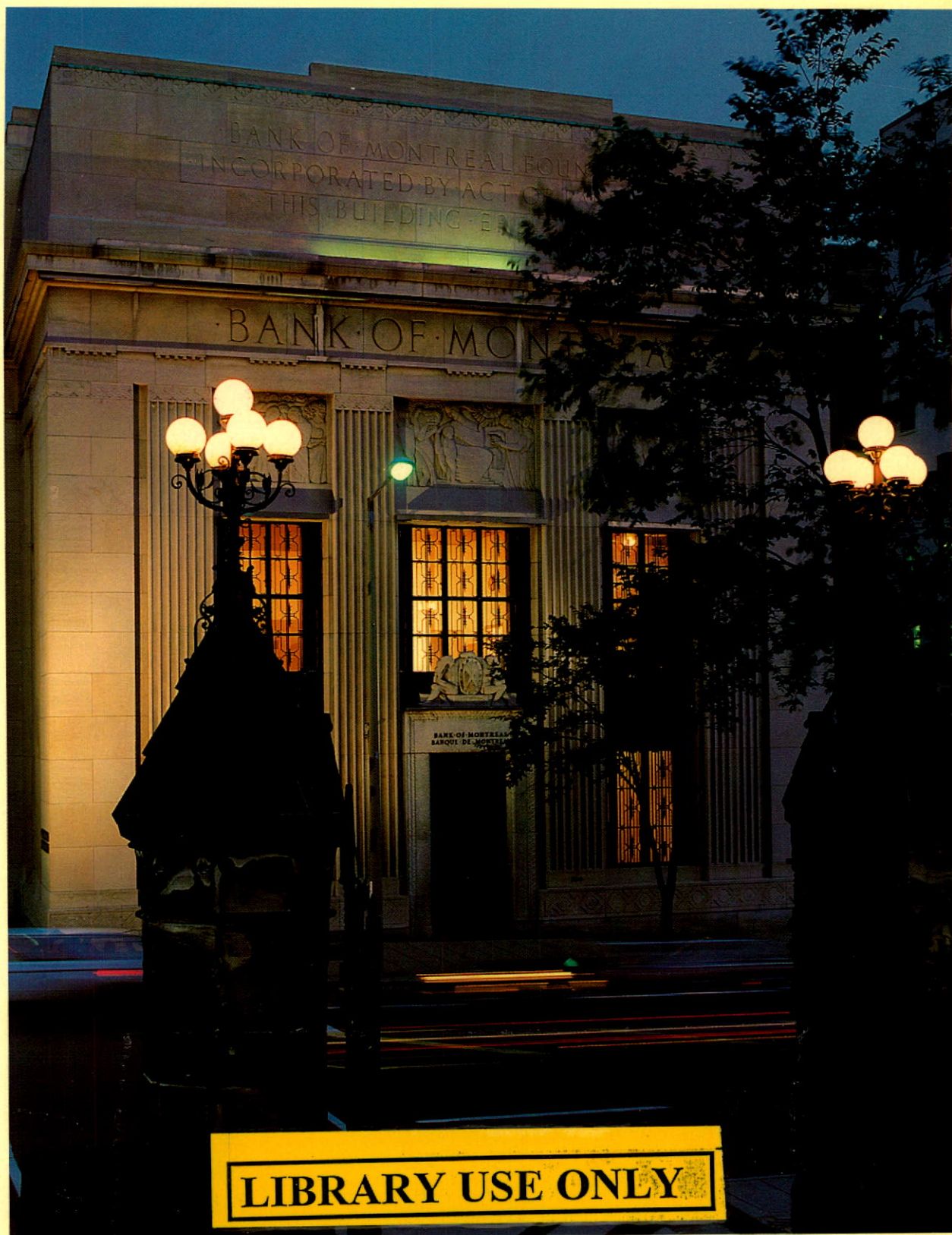


Bank of Montreal



Bank of Montreal has been present in Ottawa since 1842. The current Ottawa Main Branch, viewed here from the grounds of Parliament, was opened in 1931. During the opening ceremony, Sir Charles Gordon, then President of Bank of Montreal, said "Our endeavour has been to erect a building which will not only enhance the appearance of the Capital, but which will reflect both now and for many years the strength and solidity of the financial structure of our country."

2/	The Year's Highlights
3/	The Chairman's Letter to Shareholders
7/	The Year in Review
	<i>Report from the President</i>
	<i>Profile: The Bank's Business</i>
	<i>Bank Markets</i>
	<i>Personal Banking</i>
	<i>Canadian Commercial and Agricultural Businesses</i>
	<i>Corporations, Financial Institutions</i>
	<i>and Governments</i>
	<i>Harris Bankcorp, Inc.</i>
	<i>Domestic Operations and Electronic Data</i>
	<i>Processing Systems</i>
	<i>Risk Management and Control</i>
	<i>Corporate Activities</i>
27/	Management Analysis of Operations
43/	Annual Financial Statements
69/	Investor Information
71/	International Advisory Council
72/	Directors of Bank of Montreal
73/	Executive Officers



The Year's Highlights

For the Year Ended October 31

(\$ in millions except per common share amounts)

	1985	1986	Increase (Decrease) %
Earnings Information			
Net income	\$ 339	\$ 353	4
Dividends			
Common shares	149	158	6
Preferred shares	57	57	—
Balance Sheet Information			
Total assets	\$82,420	\$87,180	6
Liquid assets	21,429	23,963	12
Loans (net of loan reserves)	51,966	54,471	5
Loan reserves	1,266	1,586	25
Deposits	71,388	74,876	5
Capital and contingency reserves	3,452	3,645	6
Common Share Information			
Number of common shares	77,425,769	81,264,666	5
Number of common shareholders	99,065	91,225	(8)
Net income per common share			
Basic	\$ 3.75	\$ 3.70	(1)
Fully diluted	3.64	3.59	(1)
Dividends declared per common share	1.96	1.96	—
Book value per common share	33.77	34.91	3
Contribution to shareholders' equity from Shareholder Dividend Reinvestment and Equity Purchase Plans	172	122	(29)
Other Information			
Number of branches	1,220	1,220	—
Number of employees	33,281	32,988	(1)

The Chairman's Letter to Shareholders

On the pages that follow, we report on the business of the Bank in the year just past. But, a bank is more than a business.

Banks serve vital economic and social purposes in society. They provide the reliable machinery, at an affordable cost, which is required to carry out millions of individual transactions each day. They provide a secure depository for the savings of the public, and they are a source of funds for credit-worthy borrowers in the pursuit of their personal and business affairs. Furthermore, banks, through consistent and even-handed application of sound credit standards, play an important role in the efficient and equitable allocation of a scarce resource — the savings of the community.

So, every bank operates on the basis of unique powers granted to it through Parliament by society. Our business rests, more than most other businesses, on public confidence, not just in our financial stability but also in our integrity and fairness and in our ability and willingness to perform the roles which society expects of us. The preservation of a bank as a healthy, growing institution and its capacity to serve the interests of its shareholders, customers and employees depends greatly upon the preservation of this supportive consensus. Without this confidence, the political consensus from which the grant of powers to financial institutions stems will erode.

The most important discipline in any bank, however, comes from within — from the integrity of the people who carry out the business of the bank, from their commitment to basic ethical and equitable principles and from their understanding and acceptance of their responsibilities.

This sense of responsibility is what disciplines a bank and guides it constantly in the service of both the specific and the broader purposes expected of it, a discipline as it were on the more impersonal disciplines of the market.

These observations are prompted by two related series of events of the past year which may be expected to cast their shadow well into the future.

One is the sea change in public and official thinking about Canada's place in the world economy and the role to be played by the financial industry in securing that place.

We have entered a period when banks and other financial institutions are likely to be granted extended powers. This approach is essential to securing the continued strength of the Canadian financial industry in the face of a world market changing not just by degree but in kind. Nevertheless, governments and thoughtful people in the industry are already grappling with the complexities of devising a regulatory framework for financial institutions which, even under existing rules, are active in the world markets in an environment characterized by aggressive employment of technology, rapidly evolving markets and expanded business powers — without impairing the ability of these institutions to compete effectively with their foreign-based peers.

If anything, this will sharpen the challenge of maintaining the supportive consensus upon which financial institutions depend so heavily. With added powers, greater responsibility will fall on financial institutions to impose disciplines on themselves and to demonstrate consistently that the powers granted to them are being used prudently, responsibly and in the best interests of the community.

This will not be quite as easy as it sounds. We shall all be, to some extent, entering upon new ground, and we shall all certainly be exposed to the risks and exogenous shocks of a less stable world than we have been used to.

Second, recent trends and events have created a growing sense of public unease. I refer both to the wave of corporate takeovers and to disclosures of breaches of trust by parties directly or peripherally involved in the financial industry.

These events — or more precisely, the concerns they engender — have the potential to undermine the delicate consensus that has sustained the more market-oriented policies of governments in the last few years. Because financial institutions inevitably are associated in the public mind with these events, they could also undermine the supportive consensus which is so necessary to the well-being of our financial institutions.

Corporate takeovers are not *per se* bad or even necessarily unconstructive. Sometimes two plus two does equal five, but equally it can sometimes equal only three.

Corporate takeover activity should not only serve a basic economic purpose — that is, provide net value added — but it must be seen to do so.

Those engaged in takeovers and acquisitions argue, sometimes correctly, that they serve a legitimate economic and social purpose. They identify areas of opportunity and by their actions force a more efficient use of capital.

Even when true, this is a tough argument to sell. But, try selling it to the employees of a business that is dismembered or a plant that is shut down to help finance the acquirer's purchase or to turn a quick profit.

Multiply this many times over and it is not difficult to see how easy it is to risk destruction of the very basis of the political consensus on which a market economy ultimately rests.

That consensus is based on the still widespread feeling that everybody has a stake in our system, that some fairly traditional values—like hard work, saving, discipline, etc.—will serve everyone because, as cruel as the market can be at times, it gives everyone an equal chance. The market, in brief, dispenses a certain rough justice.

The market does work and, when it is allowed to do so, it works well. It is also at times an eloquent messenger, sometimes provoking a response analogous to “shooting the messenger”.

We all know that years of high inflation have distorted values so that it is often cheaper to buy than to build. We also know that in recent years while money became frighteningly expensive, it never became “tight”. And, we also know that the cumulative effect of government regulation at all levels has been to add enormously to the time, the cost and the risk of building anything.

These are some of the reasons why we have takeovers that contribute no added value instead of more new investment. We can not change the past but we can accept the greater need, imposed upon us by the times, for restraint and responsible business conduct. In other words, heed the message; don’t shoot the messenger.

It would be shortsighted to tolerate a standard of business conduct which engenders public cynicism or creates suspicion that it is possible to benefit from inside information, from tax loopholes, from adroit manipulation of the law, from privileged access to other people’s money or from political and financial connections.

Those who build factories and offices, create jobs and income, pay taxes and sustain communities, meanwhile, not only receive no encouragement, but are vulnerable to the raider and must live with the concern that what they have built may be destroyed.

Can one reasonably expect to sustain indefinitely political support for government policies that allow the market to operate relatively free of intervention under such circumstances?

I hardly think so.

Directors

We were all saddened by the death during the year of H. Roy Crabtree of Montreal, in his 69th year, and 30th year as a director of the Bank. Throughout his productive life, Roy contributed greatly to his city and country in the business, social and cultural spheres. As the senior member of the Board of Directors, Roy’s wise counsel and fine judgment, always offered with warmth and humour, were often sought and always valued. We shall miss him as a friend and a colleague.

Dr. Antonio Gallotti of Rio de Janeiro, Honorary Chairman and a founding member of our Brazilian Advisory Board, passed away in December 1986, a sad blow to his friends and associates both within and outside the Bank. Dr. Gallotti had a long and distinguished career in business and in the world of affairs. His presence will be missed by all.

Bruce I. Howe resigned from the Bank's Board on November 30th, 1986 in order to accept appointment to the Public Service of Canada as Secretary to the Minister of State for Science and Technology. We wish him well in this new endeavour and feel fortunate that, notwithstanding our loss, men of his calibre are willing to commit themselves to public service.

Sir Guy Henderson, a director of Bank of Montreal Bahamas Limited since 1971 and a former Chief Justice of the Bahamas, will be retiring during the coming year. Sir Guy has been a pillar of strength and a wise counsellor and in his well-earned retirement has our gratitude and best wishes.

Three directors of the Bank will retire at the forthcoming Annual General Meeting, having reached the mandatory retirement age for directors. They are Hon. Sidney Buckwold of Saskatoon who has been a director since 1970; Fred H. McNeil of Granum, Alberta, former Chairman and Chief Executive Officer who served the Bank as an executive officer from 1966 until his retirement and as a director since 1973 and Lucien G. Rolland of Montreal, who has been a director since 1960. Each of these senior members of the Board has served on various committees, including the Executive Committee, contributing generously of their time as well as their experience and judgment. We face the loss of their mature advice with much regret.

Your Board is recommending the election of three new directors at the forthcoming Annual General Meeting. Eric H. Molson is Deputy Chairman of the Board, The Molson Companies Limited. With his election, Mr. Molson will be continuing a family tradition that goes back more than 160 years. Jeremy H. Reitman, of Montreal, is President of Reitmans (Canada) Limited, one of this country's leading retail organizations. Charles N.W. Woodward of Vancouver is Chairman of the Board and Chief Executive Officer of Woodward's Limited, a major Canadian retailer. Your Board believes that these notable Canadians will make substantial contributions as the Bank faces the challenges of the years ahead.

As a result of these changes, the Board of Directors will be reduced in size to 37 members.


William D. Mulholland
Chairman of the Board

Report from the President

Prudence and integrity, profitability, customer service and efficiency have been the central themes emphasized by the Bank during the past year. These are by no means new to the Bank; but their importance has been heightened by rapidly changing, highly uncertain and increasingly competitive markets at home and abroad.

The Bank's attention to sound practices and integrity has been reflected in many ways. One is the decision early last year to revalue our entire energy sector loan portfolio using a valuation assumption of U.S. \$15 per barrel, unescalated, after adjustments to recoverable reserves and the deduction of provisions for expenses and contingencies. This resulted in an increase in reservations of over \$250 million. Reservations on sovereign loans were also increased in keeping with the Inspector General's requirement in respect of the level of reserves in 1989. Net new reservations on the remainder of the portfolio declined, in part reflecting the more effective system of credit assessment and controls implemented in recent years.

The Bank's liquid assets continued at a high level, averaging 27% of total assets in 1986. Equity capital increased \$192.4 million in 1986 through earnings retention and various shareholder reinvestment programs. The ratio of capital and contingency reserves (excluding reservations for loan losses) to total assets was 4.2% at year-end, unchanged from October 31, 1985.

Continuing improvements have also been made in the Bank's monitoring, reporting and management information systems and in its internal auditing systems. Most important of all, perhaps, has been the reinforced commitment throughout the Bank to sound banking practices.

A second key priority has been to improve profitability. For the year, reported net income was \$353.0 million, an increase of 4% notwithstanding the

increase in loan loss reservations due to oil. Excluding the impact of oil, reported net income would have been about 18% higher than in 1985. Net interest income increased by 6%, even though net interest margins were down because of foregone interest on petroleum-related loans, lower international money market spreads and relatively stronger growths in loans and securities with below-average spreads. Other operating income increased 20%.

Harris Bankcorp, Inc. had an excellent year. Its net earnings in 1986 totalled \$97 million and, after adjustments, contributed 23% of the Bank's total reported net income.

Major initiatives were undertaken during the year to improve profitability. Among these was an extension of the account responsibilities of the Commercial Banking Group. This will increase the focus on commercial lending to small and medium-sized business in Canada. In addition, more effective systems have been developed to assess the profitability of our banking relationships to weed out activities that do not meet reasonable levels of profitability and to expand activities that do. Pricing policies are being regularly reviewed and adjusted as appropriate. At the same time, increased attention is being focused on tapping new sources of stable and relatively cheaper deposits.

Service to our customers — the third major priority — is fundamental to the Bank's success. The Bank established a new Capital Markets Group to provide a visible focus for such activities throughout the world. This Group, with subsidiaries in London, Sydney and Singapore and offices in Toronto, Tokyo and New York, will continue to provide a high level of service to corporate and institutional customers.

Enhanced services were also introduced during the year to various customer groups, as described in more detail within this report. Of particular note are the point-of-sale terminals at all company-owned

Beaver Lumber stores across Canada; the Instalment Loan Plan for independent business; Electronic Customer Access for corporate cash management clients; and an electronically-based system to handle documentary credits for importers and exporters.

The Bank's goal is to provide our customers with the best service possible. It is important to us that their transactions are carried out speedily and efficiently. The pages that follow refer to many initiatives, including a computerized credit support system to help personal lenders provide faster decisions, expanded customer access to automated banking machines throughout North America and improved hours of service at branches. A separate Domestic Operations unit, with its own management and with the sole responsibility of providing effective and efficient back-office operations and service to all customers in Canada, was established this year to carry out our commitment to service.

The fourth priority is improved productivity and efficiency. Heavy investment in mechanization and technology reduced costs while improving service. Combined with various other measures to control costs, this resulted in a reduction of the ratio of non-interest expenses in the Parent Bank to under 2% — despite an increase in capital taxes and Canada Deposit Insurance Corporation (CDIC) premiums of 124%. Total Parent Bank non-interest expenses in 1986 rose 5.7%, 3.3% if capital taxes and CDIC premium increases are excluded.

At the end of 1986, the Bank's consolidated assets totalled \$87.2 billion — \$4.8 billion or 5.8% greater than a year earlier. This increase was largely concentrated in mortgages and personal loans, and in liquid assets. Commercial loans remained at about the same level as in 1985. On the liabilities side, growth occurred mainly in notice and term deposits; demand deposits were little changed.

Summing up, the Bank's financial results in 1986 were less favourable than expected a year ago primarily due to its decision to face up immediately to the full impact of the fall in oil prices on its oil-related loans. The figures, however, mask substantial improvements in many aspects of the Bank's operations: in interest and non-interest earnings, in the quality of assets and earnings, in internal monitoring and controls, in the focus on more profitable activities, in the range of products and quality of service offered to customers, in productivity and efficiency, in organizational structure and in the Bank's resource base of people, technology, liquidity and capital.

These improvements reflect the dedicated work, skill and abilities of the Bank's 32,988 employees, including 4,834 at Harris.

At this stage the prospects for 1987 look favourable. The Bank's plans call for further improvement in its asset mix, reduced funding costs, an improvement in loan loss experience and continued strong expense control. With the impact of the recent decline in oil prices already fully absorbed, and with what has been accomplished in 1986 and our strong resource base, the Bank looks forward to improved results in 1987. The challenge is to continue to concentrate on our priorities and to take full advantage of our strengths.



G.L. Reuber
President and Chief Operating Officer

Profile: The Bank's Business

Bank of Montreal serves personal, commercial, institutional and public sector customers in Canada, the United States and abroad. The banking groups described below manage specific aspects of customer relationships. Their responsibilities encompass marketing, transaction processing, and development and delivery of new banking services with a shared focus on quality customer service. They are supported by staff groups in credit policy, financial reporting and management information, and human resources.

In 1986, the Bank consolidated Domestic Operations to handle the processing of virtually all personal and commercial banking customers' transactions nationwide.

Personal Banking Group provides deposit, loan and card services to some 4 million customers through the Bank's domestic branch network. The Group has some \$25 billion in personal deposits and \$14 billion in personal loans, including residential mortgages.

Besides some 1,179 Bank branches operating "on-line" and in "real time", and a growing number of Instabank® automated banking machines, the Bank's Canadian delivery system includes MoneyTrac™ statement printers and shared ABM networks in Canada and the United States. No Canadian bank provides its customers with access to more ABMs (some 19,000 at the end of 1986) in North America.

Commercial Banking Group focuses on four sectors in Canada — small, medium-sized and agricultural businesses, and local government bodies. Account management officers are based in 74 Commercial Banking Units and in "satellite" offices in some 350 branches across the country.

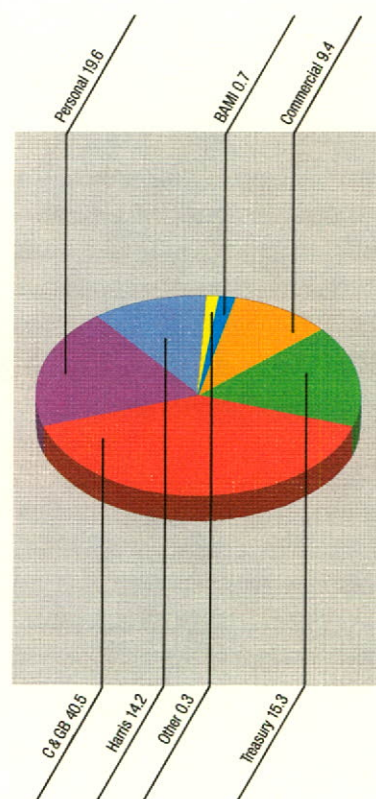
Corporate and Government Banking Group, with offices in key business centres, manages the Bank's relationships with a client base of national and multi-national corporations in Canada, the United States

and abroad, and with governments and financial institutions. Total Group assets were approximately \$30 billion, primarily in commercial loans.

Non-credit services play an increasing role; the Group has specialized teams for cash management and trade finance services, and it works closely with Treasury and Capital Markets Groups.

Treasury Group, dealing and operating in major centres in North America, Europe and Asia, provides foreign exchange, money market, domestic bond underwriting and financial risk management services to customers directly and in conjunction with the other banking groups. Total trading volumes amount to over \$13 billion daily. Treasury Group also manages the Bank's liquidity reserves; wholesale deposits; foreign exchange, domestic

Credit Assets by Banking Group
(%)

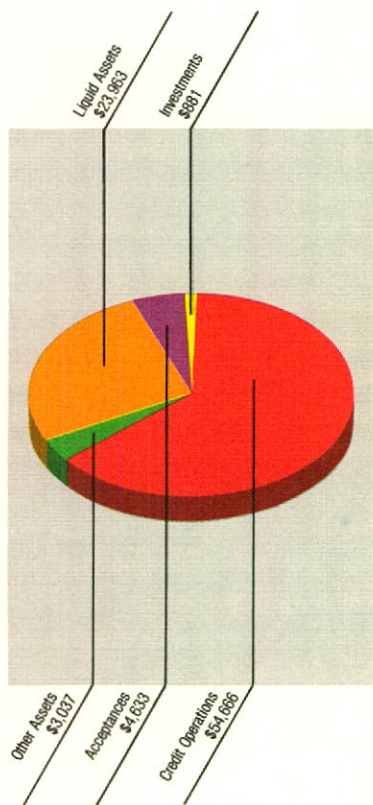


bond, and money market trading; international payments and international branch network.

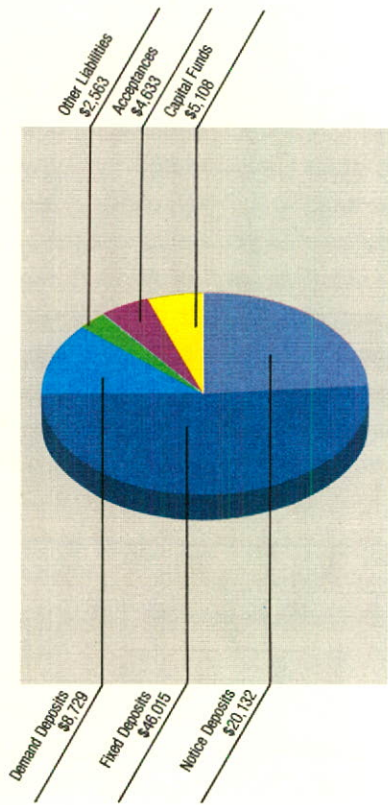
Capital Markets Group is a consolidation of existing securities underwriting, trading and distribution functions; corporate finance and merger and acquisition advisory services. It is the focal point for the Bank's capital markets activities in London, Tokyo, Singapore and Sydney.

Harris Bankcorp, Inc. of Chicago serves small and medium-sized businesses throughout the U.S. Mid-West and corporate customers across the United States with trust and commercial banking services. Through nine affiliate banks in Chicago and its suburbs, Harris Bankcorp is a major factor in the Chicago retail banking market. Consolidated Harris Bankcorp assets were U.S. \$9.7 billion at the end of 1986, while trust assets totalled approximately U.S. \$50 billion.

Use of Funds
(\$ in millions)



Source of Funds
(\$ in millions)



Bank Markets

Personal Banking

Personal deposits are the primary source of funding for the Bank's Canadian lending activity. In 1986, personal chequing and savings balances grew to \$24.3 billion, and represented 73% of the Bank's Canadian dollar deposits. Protection of depositors' funds and confidentiality of customer information are of paramount importance. Competitive rates, services and customer convenience are the ingredients that the Bank emphasizes to maintain this stable source of funds.

For example, the Bank now offers Investment Chequing™ Accounts in both Canadian and U.S. dollars. These provide varying interest rates on tiered account balances. Transaction charges were eliminated on all Canadian and U.S. dollar personal accounts that maintained a specified minimum monthly balance.

Instant tax receipts were introduced early in the year to enable Registered Retirement Savings Plan customers to file their income tax returns sooner. Bank of Montreal was the first major financial institution to offer this service, and it contributed to growth of nearly 21% in RRSP balances during 1986.

Banks, unlike many other financial institutions in Canada, are required to maintain interest-free and low-interest reserves with the Bank of Canada, based on the total of deposit balances. For Bank of Montreal, these reserves average approximately two billion dollars. The fact that these reserves earn so little income adds significantly to the Bank's cost of funds.

Deposits in Canada of up to \$60,000 per customer are insured through the Canada Deposit Insurance Corporation. In 1986 the premiums paid increased 164% to \$19.8 million. This reflects an increase in premium rates legislated by Parliament to replenish

the resources of the insurance fund which had been depleted by claims of depositors in failed institutions.

The number of MasterCard® cardholders increased by 19%. The more than two and three quarter million Canadians who carry Bank of Montreal MasterCard accounted for 108 million transactions during the year. The number of merchants accepting MasterCard for customer purchases increased by 18%, and resulted in a significant increase in merchant discount revenue. Bank of Montreal has maintained its "no fee" policy on these cards. More customers are now using MasterCard Gold Card, which includes an extensive package of banking services, including a preferred rate line of credit, for a single fee.

The Bank has begun installing electronic point-of-sale terminals in merchant locations across Canada to improve the purchase authorization process. In addition to improving customer service, they are expected to reduce credit and fraud losses.

Bank MasterCards and Multi-Branch Banking® cards are now used for more than one-third of all personal banking transactions. More than 70 million transactions were conducted at Instabank automated banking machines during the year. There are now more than 650 Instabank machines across the country, in 49 centres, with units having been added in 1986 in Chicoutimi, Sherbrooke, St. John's, Thunder Bay, the Okanagan Valley and 15 other communities. Instabank machines can be used to withdraw cash, make deposits, pay bills, transfer funds between accounts, and display account balances (including term deposits, U.S. dollar accounts and personal loans). They handle up to 10 accounts per customer. Instabank machines are available virtually 24 hours a day, 7 days a week.

™ - Trade Mark of Bank of Montreal.



* - Bank of Montreal is a registered user of the MasterCard Trade Mark owned by MasterCard International Inc.
* - Registered Trade Mark of Bank of Montreal.

These are being supplemented by the Bank's MoneyTrac statement printers, which provide up-to-date printed statements of customers' account status.

As a result of connections between Instabank and other automated banking machine networks, Bank of Montreal customers now have access to their accounts at more than 19,000 machines in North America. These networks include CIRRUS®, Interac® and Circuit®. No other financial institution in Canada offers its customers access to as many North American locations.

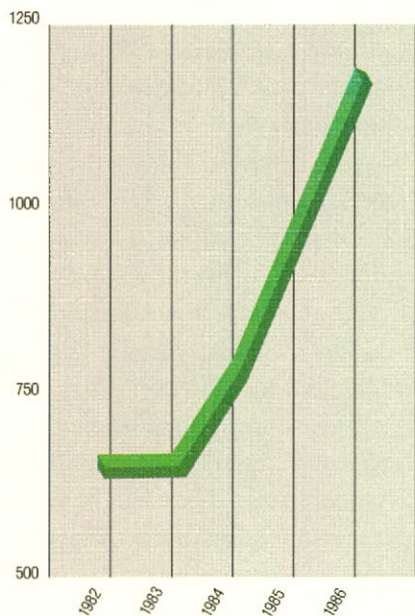
Lending to personal customers, by means of instalment loans, demand loans, lines of credit, credit card balances and other products, increased by 13%.

An automated personal credit support system designed to help lending officers provide same-day response to most loan requests was introduced late in the year. National coverage is planned within the next two years.

Lower mortgage rates during 1986 created a buoyant real estate market in much of Canada. Bank of Montreal responded by offering a broader array of mortgage alternatives to customers; residential mortgage business increased by 26% to \$7.4 billion by year-end. More customers are currently choosing longer-term fixed rate mortgage loans, while a new "portable" mortgage allows a customer to transfer an existing mortgage to a new home.

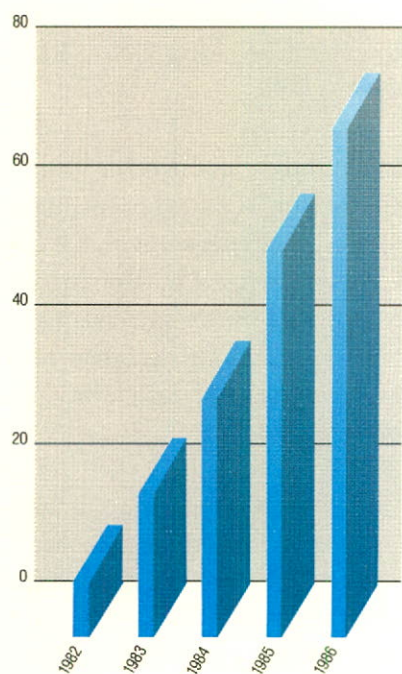
MasterCard Growth

(outstandings — \$ in millions)



Instabank Growth

(Millions of transactions by customers on Bank of Montreal Instabanks)



* - Bank of Montreal is a registered user of the Interac Trade Mark owned by Interac Inc.
* - Bank of Montreal is a registered user of CIRRUS Trade Mark owned by CIRRUS System Inc.
* - Circuit is a registered Trade Mark of Bank of Montreal.

Personal investors can choose among a variety of Bank instruments that offer competitive rates of return. Redeemable term deposits are offered by the Bank, and Guaranteed Investment Certificates by Bank of Montreal Mortgage Corporation. The First Canadian Mortgage Fund, a mortgage-based mutual fund managed by Bank of Montreal, provides investors with a superior rate of return and is the only mutual fund in Canada with an AAA rating by the two major Canadian bond rating services. In 1986, the Fund grew by 42%. Besides offering personal investors a superior combination of return and security, these instruments provide the Bank with stability of funding and help to control its exposure to interest rate changes which, in turn, permits it to offer the same benefit to its borrowing customers.

Despite the increasing popularity of automated banking, the prime point of contact with the Bank for most customers remains the local branch. The full range of personal banking services is available in the Bank's 1,179 branches in Canada. Most of these branches offer extended hours of service and over one-third are open on Saturdays, more than any other financial institution. Excellence of service to customers remains a high priority. Frequent surveys of Bank customers are conducted to monitor performance and identify areas for improvement.

ABMs Available to Bank of Montreal Customers

	INSTABANK	CIRCUIT	INTERAC	CIRRUS
Network Size	Over 650 Instabanks across Canada	Over 1,000 ABMs across Canada (including Instabanks)	Currently 4,000 ABMs across Canada (including Instabanks)	Over 14,000 ABMs across the U.S.A. and over 1,000 machines in Canada (existing Circuit members are also members of CIRRUS)
Transactions Available	Cash withdrawals, deposits, bill payments, account balances, all from up to 10 accounts; MasterCard direct cash advances.	Cash withdrawals from primary savings or chequing accounts up to normal daily card limit. MasterCard direct cash advances up to normal daily card limit. Balance inquiries available at CIRRUS & Circuit locations.		
Card	Full access with an encoded MBB or MasterCard card. Direct cash advances with MasterCard card.	Striped MBB or MasterCard card. Direct cash advances with MasterCard.		

Canadian Commercial and Agricultural Businesses

Smaller businesses in Canada have two basic banking needs — deposit and payment services, and credit to finance operating and capital requirements. As such businesses grow, they also require more specialized services, such as foreign exchange, cash management and trade finance — all of which can be accessed through commercial banking officers. Until they develop significant foreign-based operations, most Canadian-based companies, including some of considerable size, find their service requirements are best met by the Commercial Banking Group.

Commercial account management is based in Commercial Banking Units and “satellite” offices across Canada. Day-to-day transactions are processed through Bank branches. The consolidated Domestic Operations organization, described on page 20, will bring a sharper focus on improved transaction-processing procedures and standards, on responsiveness to customer needs and on specialized training for professional operating staff. This will streamline document processing and provide on-line information to staff dealing directly with customers.

The improvements in the credit process, which began in 1982, continue to bear fruit. Faster turn-around time on credit applications was made possible by ensuring that decisions on virtually all commercial loans could be made at the Commercial Banking Unit. Commercial Banking Group profitability has improved and this trend is expected to continue in the coming year. A computer-based account manager support system, to be installed beginning in 1987, will provide on-line account history and portfolio information. This will enable bankers to improve further the quality of customer service and turnaround time.

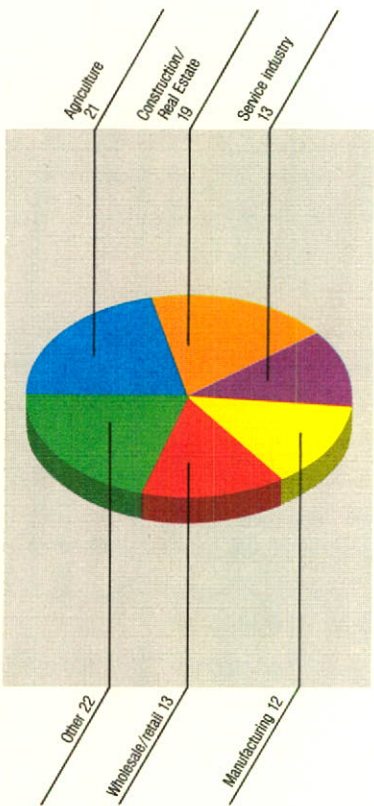
The cornerstone of the Independent Business Program, is the FirstBank Operating Account.®

This account provides simplified administration and fee structures, and eliminates the need for the customer to sign a note for each new advance. The Instalment Loan Plan was introduced this year featuring fixed interest rates with repayment flexibility.

An increasing number of companies are using the Bank’s foreign exchange services, with transactions occurring in more than fifty currencies. Bank of Montreal provides an on-line foreign exchange rate quotation service in all branches and Commercial Banking Units. Foreign exchange transaction processing is also automated.

The number of Automotive Finance Centres was increased from six to fourteen. The result was a

Commercial Banking Group Loans by Sector
(%)



® - Registered Trade Mark of Bank of Montreal.

380% growth in automotive dealership financing. The Centres also make car loans to dealers' customers and provide a major boost to the Bank's consumer loan business. Six more Automotive Finance Centres are to be opened in 1987.

With the substantial growth of franchising in the retail sector, the Bank is building long-term relationships with franchisors. Special programs facilitate borrowing and custom-tailor services to each client's needs. These programs also include such "value-added" services as cash management, treasury, disbursement and point-of-sale MasterCard service. Such initiatives have resulted in significant growth in loan volumes to franchise customers during the year.

Specialized Real Estate Units in several parts of the country meet the particular needs of this industry.

The Bank has been, historically, a major participant in serving the agricultural sector. Notwithstanding current problems being experienced by this industry, the relationship is expected by the Bank to continue. The agricultural portfolio is sound. This reflects the ability of most farmers to manage their operations effectively and the Bank's experience in making agricultural loans as well as in working with small and large farming customers. The Agri-Services group was strengthened through training and recruitment. This will help the Bank to improve its ability to help individual producers overcome short-term difficulties, and to realize on the long-term prospects for the industry.

The Bank continues to expand its business with municipalities, schools, hospitals and other public service organizations, each requiring specialized services. These customers have a particular need to manage public funds efficiently and to protect themselves against undue financial risks. The Bank offers them secure investment vehicles, greater interest rate stability and improved cash flow

planning. The range of services includes various forms of short- and long-term financing, fixed rate loans and specialized services in municipal underwriting and bond trading.

Multinational Corporations, Financial Institutions and Governments

This area of the Bank's operations — because it deals with major multinational and foreign-based customers, as well as those in certain international industries — is most sensitive to the changes in international financial and commodity markets. These changes continued unabated in 1986. They were typified by developments in London, the Bank's most important market outside North America, where effective elimination of barriers between banking and brokerage set off intense competition.

Financial markets were further buffeted by imbalances in international trade and payments and in national fiscal policies, by declines in oil and non-oil commodity prices and, in consequence, sharp changes in exchange rates and in interest rates. This brought increasing demand for protection from exposure to exchange and interest rate fluctuations by corporations, institutions and governments. The result was that non-credit services assumed increasing importance relative to traditional corporate lending. Both the compression of loan spreads and the longer-term trend among major corporations to undertake in-house many of the activities traditionally provided by the Bank affected the profitability of corporate lending.

The Bank's approach has been to focus on those major markets where a comprehensive infrastructure can be supported and upon those customers with whom a banking relationship provides adequate value added for both parties. The Bank consequently expanded capital markets and treasury services, cash management and other fee-based products, and concentrated on relationship management of

important corporate and institutional accounts in the Bank's key markets.

To strengthen the support of its corporate, government and institutional customer base, the Bank established a Capital Markets Group based in Toronto and Bank of Montreal Capital Markets Limited, headquartered in London. The activities of this subsidiary include Eurobonds and Euronotes, securitized lending, government bond trading and underwriting, and merger and acquisition advice. The Capital Markets Group is also active in other major financial centres.

This activity was complemented and reinforced by the Bank's strength in foreign exchange dealing, which is carried out on a 24-hour basis. The strength of the Bank's foreign exchange dealing was evident in 1986 when a "Euromoney" magazine survey of multinational corporate financial officers ranked the Bank 6th in the world in commercial foreign exchange and, again, the top Canadian bank. In a related area, the Bank's U.S. dollar deposit services to Canadian customers have been reflected in its exceptionally strong market penetration.

Other services drew on the Bank's technological capacity to meet customers' need for fast, accurate information and advice. A new Market Monitor service provides customers with direct electronic access to market data and commentary. A Risk Management Advisory Service helps corporations make the best use of such diverse instruments as interest and currency options, interest rate protection agreements and swaps.

Most new corporate lending was to commercial and industrial customers in Canada and the United States. Here, too, the Bank augmented traditional lending activity with new services. In the area of trade finance, for example, a new computerized system processes documentary credits, for centuries a basic financial instrument for facilitating trade.

This system is unique in Canada. It allows importing customers to initiate the preparation of a credit, amend a previously issued credit or review directly the status of outstanding transactions. Most importantly, it has accelerated the credit issuance process and virtually eliminated costly delays associated with follow-up instructions and changes.

In other improvements designed to meet customer needs, the DirectLine® system was enhanced through Electronic Customer Access. This allows users to transfer high volume disbursements, such as payroll and dividend payments, directly to their customers' accounts. It also augments the users' existing capacity to get on-line access to account information. In addition, electronic funds transfer systems were upgraded in New York and Toronto with other centres scheduled for upgrading in the coming year. These systems allow the rapid, trouble-free movement of large payments and facilitate better management and control of "daylight overdraft" balances resulting from pre-settlement funds transfers amongst banks.

The Bank's cash management and security custodial arrangements for non-bank financial institutions continued to be a significant source of fee income and deposit business. A broadened range of products for investment dealers led to a substantial increase in revenue. Investment dealers were particularly responsive to the introduction in 1986 of a Letter of Credit to secure borrowings of stocks and bonds, an attractive alternative to the traditional use of Treasury Bills to secure such debt.

Business with the public sector — federal and provincial governments in Canada and sovereign borrowers abroad — remained important. In 1986, the Government of Canada, in furtherance of its policy of improving the efficiency of financial management, "unbundled" its business with Canadian chartered banks. Previously, the Government had placed interest-free deposits with

* - Registered Trade Mark of Bank of Montreal.

banks in exchange for banking services covering funds collection and disbursement. Now, banks pay interest on deposits and are paid for services rendered. This step will promote the more productive use of public funds and complements other Government actions to reduce the cost of its operations.

Other initiatives to make more efficient use of banking services by the Government included the acceptance of credit cards for licence fees and excise duties, and the direct deposit in recipients' bank accounts of such entitlements as family allowance and old age security payments.

The Bank provides cheque disbursement, funds consolidation, payroll and pension, fiscal agency and securities underwriting services to various governmental entities.

A dominant concern internationally for governments and banks alike was the effect of oil prices on sovereign borrowers. The decline in oil prices had differential impacts on various countries depending on whether they were net importers or exporters. Comparable differential impacts were felt in Canada and the United States among companies and regional economies.

Mexico, heavily reliant on export earnings for foreign exchange to service its foreign debt, was particularly hard hit by the price decline. The Bank was closely involved in efforts through multilateral organizations and the banking industry to resolve the immediate difficulties posed by revenue shortfalls. While these were successful in the short-term, the longer-term problem remains, namely, to restore the country to a sound economic position through policies which will restore economic growth after four years of austerity.

Brazil, on the other hand, is a net importer of oil and benefitted from the price decline, as well as

from basic economic reforms which contributed to a high growth rate, reduced inflation and a substantial trade surplus. The beneficial effects of these reforms, however, showed signs of weakening toward the end of the year. Brazil's long-term prospects are good, assuming that reasonable momentum toward economic equilibrium can be maintained.

An important component of the Bank's operations in Brazil is conducted through its wholly-owned subsidiary, Banco de Montreal Investimento S.A.-Montrealbank (BAMI). BAMI is active in investment management and capital markets operations for pension funds, indigenous and multinational corporations and individuals, as well as in the provision of financial services to commercial and personal clients. Credit outstandings reached nearly Cdn. \$550 million. Funding comes from local deposits, non-Brazilian liabilities and Brazilian and foreign official financing programs. BAMI's Treasury operations, whose daily average trading volume now exceeds Cdn. \$200 million, are complemented by foreign exchange services.

In Asia, the Bank continued to build its relationship with the Government of China. In August, an agreement was signed with the Agricultural Bank of China to establish a correspondent banking relationship and to promote joint ventures and the exchange of technology between Canada and China. The Bank already serves as financial advisor to a number of governmental entities and is actively engaged in the financial planning of several important projects.

Harris Bankcorp, Inc.

Since the acquisition of Harris two years ago, it has generated record profits. The Bank's wholly-owned subsidiary continued to exploit the potential opened up by its association with Bank of Montreal. As well, Harris continued its strategy to penetrate Chicago's growing suburban personal and commercial markets through its affiliate banks, which are proving to be both profitable and an important and stable funding source.

The year brought increasing recognition by customers in both Canada and the United States of the increased capabilities that result from Harris' connection with the Bank.

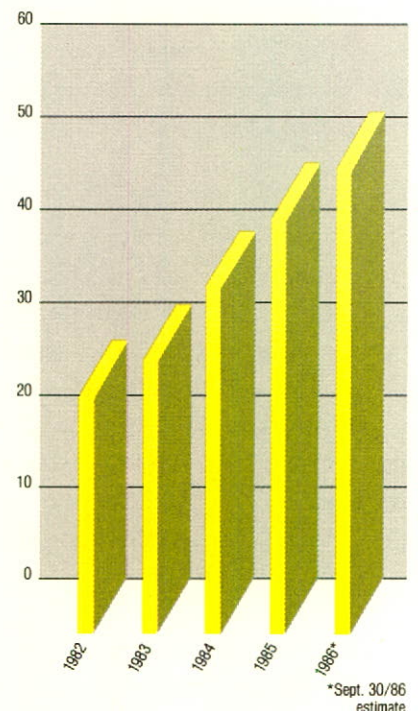
Independent national surveys rated Harris' operating capabilities in corporate banking among the top two or three in the United States and first in the Chicago market. Two-thirds of corporate customers consider Harris to be a "relationship bank"—only one other American bank was considered better in terms of this attribute among corporate customers. Harris' master trust and other trust operations received comparable recognition.

Harris' record performance also reflected solid progress in investment management throughout the United States, in its commercial banking in the American Mid-West and in its personal banking in and around Chicago. These markets were generally buoyant for much of the year, although growth was slower than in previous years.

The subsidiary continued to make plans for improved performance in future years, through new and customized products for corporate customers and joint efforts with Bank of Montreal in terms of international activity and in providing cross-border

Harris Bankcorp, Inc.—Trust Assets

(Trust assets under administration—in US \$ billions)



services, which the Harris-Bank of Montreal partnership is uniquely situated to do.

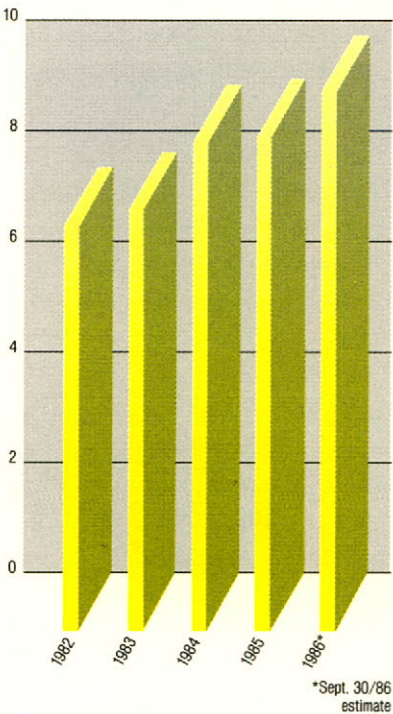
Among the customized products developed by Harris was a “lock box” operation designed to handle the complex billing requirements for a major American railroad. Harris also developed a system enabling a major oil company to automatically debit distributors’ accounts and collect and concentrate cash on a daily basis.

In other joint operations, Harris provided the facilities to clear Bank of Montreal futures transactions. The two banks moved ahead in efforts to

provide full securities services in Tokyo as well as in London. Harris’ 24-hour foreign exchange operations — it is one of the few Chicago banks to provide around-the-clock trading — continued to reinforce Bank of Montreal’s strength in this area.

These joint operations have been increasingly important in providing services that might not otherwise be available. Other cross-border services to complement the existing trans-border electronic payments system are under study. This service allows Canadian companies to make payments directly into customers’ and shareholders’ accounts in the United States and *vice versa*.

Harris Bankcorp, Inc.—Total Banking Assets
(US \$ in billions)



Domestic Operations and Electronic Data Processing Systems

Technology, primarily computerization and communications, is the basis for advances in transaction processing, banking services, communications, customer convenience and electronic banking. It also provides both more effective managerial control over operations and the information systems that support effective use of Bank resources.

In 1986, the Bank took steps, outlined throughout this report, to use technology more efficiently to serve customers. This involved expanded centralized processing and control, and more use of small-scale systems across the Bank. Office automation, sophisticated communication networks, computerized credit support systems and desk-top publishing all enabled Bank personnel to spend more time serving customers.

To further this effort, the Bank consolidated its domestic operations under a dedicated national management structure. Domestic Operations is responsible for processing most of the banking transactions of personal and commercial customers in Canada. It also manages automated facilities, such as Instabanks and MoneyTrac statement printers, and regional cheque processing centres.

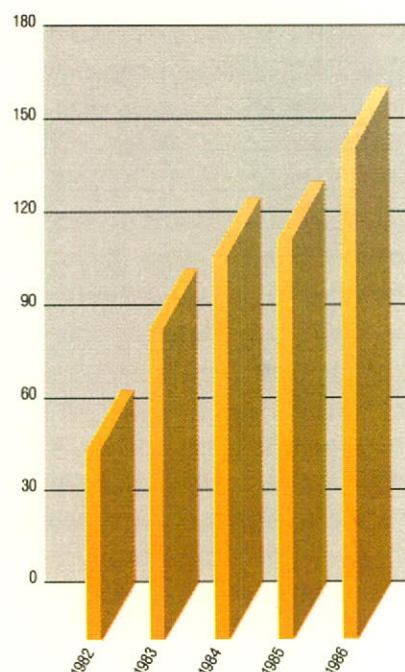
The objective of the Domestic Operations organization is to deliver high quality, cost-effective service to all Bank customer groups; to maintain processing policies and standards; and to identify automation opportunities and other ways to increase efficiency.

As much intermediate document processing as possible is being eliminated. This is being accomplished largely by providing both personal and commercial banking staff with on-line customer information and by shifting transaction entry and information retrieval to the point-of-sale.

Domestic Operations works closely with the Electronic Data Processing Systems Group (EDPS), which manages the computer and telecommunications infrastructure of the Bank. Domestically, EDPS concentrated on improved customer information; management information; expanded cash management, lending and other banking products; and new data transmission technology. Other priorities included automated securities processing in Canada, upgraded payments processing in New York and Toronto, and enhanced operating account capabilities for correspondent bank accounts worldwide.

Computer Capacity

(Number of instructions that can be executed per second by the Bank's central computing facility — in millions)



Risk Management and Control

The Bank's first priority is to ensure the safety and profitable management of the funds entrusted to it by systematically assessing and monitoring risk.

In addition to the control procedures and systems outlined below, the Corporate Audit Department conducted regular, independent audits of all areas of the Bank's operations. Together with the Corporate Security Department, it concentrated on prevention of loss or misappropriation of funds. Cases of suspected loss were investigated fully. In addition, Corporate Audit monitored all operations to ensure their compliance with legal and regulatory requirements.

Credit Risks

The credit-granting system deals with the full spectrum of risk-taking activities, ranging from consumer lending to complicated currency and interest rate swaps, including transactions which are not required to be recorded on the Bank's balance sheet. The system uses trained, knowledgeable lending officers; a *decentralized*, two-track decision process which requires a risk assessment to be made independently of line credit approval before a credit can be authorized; a sound organizational structure; and *centralized* monitoring and control. This approach has dramatically reduced controllable credit losses.

Staff training and Qualification Panels across the country support the quality of lending decisions. During 1986, 1,200 officers attended credit courses, while panels of experienced officers reviewed the professional qualifications of some 1,900 personal and commercial bankers during the year in connection with the delegation of discretionary lending authority or appointment to lending positions.

Loan officers made more than four million credit decisions in 1986 affecting more than three million borrowers. Credit granting for personal borrowers

was streamlined with help from a computer-based personal credit support system. This new system enables personal lenders to make more informed decisions quickly. Response time to consumer loan applications has already shown a dramatic improvement. The average turnaround time for commercial loan applications will similarly be improved with expanded computer support at Commercial Banking Units.

Since 1982, the Bank's loan loss experience ratio, excluding oil and gas price-related losses, has improved from 1.25% of total loans to 0.63%, including provisions for sovereign risks.

Approximately 30% of all commercial credit transactions (including all large applications from new customers) and 12% of all personal loan transactions were subjected to independent loan reviews conducted by senior officers. During the year, over 200 reviews were conducted to evaluate the credit process itself in various units of the Bank.

The Corporate Audit Department conducted 1,070 separate audits during the year, 210 of which involved audits of components of the Bank's loan portfolio.

Financial Risks

Liquidity Risk is the possibility that a bank will be unable to meet obligations to repay depositors or advance already committed monies to borrowers because assets are tied up, or because required funding cannot be obtained.

As a matter of policy, the Bank maintains levels of highly liquid assets, in Canadian dollars and other currencies, well in excess of the reserves required by regulatory authorities. At the end of 1986, 27% of total assets were in highly liquid form. The Bank has also long placed a high priority on a stable funding base. In Canada, core personal and commercial deposits are more than adequate to meet

the Bank's current requirements for loan funding. Internationally, the Bank continued to emphasize diversification of funding sources and the maintenance of a substantial pool of liquid assets.

Mismatch Risk, which arises when the nature of a bank's assets and liabilities do not exactly correspond, can take several forms. Interest Rate Risk, for example, arises when the maturities of Bank assets such as fixed rate loans are for a shorter or longer period than are the maturities of the deposits used to fund these assets. Foreign Exchange Risk generally results from open positions in foreign currencies, usually created in the process of facilitating customers' purchases and sales of foreign currencies.

The Bank has taken numerous steps to minimize and control mismatch exposures. Around-the-clock trading, global monitoring and reporting, and automatic position "switching" from one trading location to another, combine active management of exposures with informed and instantaneous market contact. The Bank continued to match assets and liabilities carefully, taking only controlled interest rate and foreign exchange exposures. Increasingly, such instruments as swaps and forward contracts were used to hedge exposures.

Other Risks

The high volume and complexity of business transactions around the world contain inherent risks of error and of fraud. A system of controls is designed to keep these operational risks to a minimum. The Bank subjects its computer systems to thorough testing and audit concurrence before any new system is implemented. Well-documented policies and procedures, and independence of operations staff from the banking functions, are the foundations of this control.

The Bank implemented a comprehensive strategy to manage such underlying business risks as public liability, property loss and fraud in 1986. This was especially timely, as the insurance market was offering lower amounts of coverage, higher deductibles and substantial premium increases. In October, the Bank established a new insurance subsidiary under professional management to handle coverage for its own operations.

The Bank's approach emphasizes:

- regular assessments of significant potential risks, amounts at risk and probability of loss.
- regular review of physical security, operating and control procedures to minimize the chance of loss.
- contingency plans to minimize the amount of possible loss.
- selection of appropriate insurance.
- close monitoring of all risks, reporting procedures and claims activity.

Conflict of Interest

In 1986, the Bank implemented a revised directors' and employees' Conflict of Interest policy and related procedures, which place heavy emphasis upon education, prevention and timely reporting.

Corporate Activities

International Advisory Council

The Bank has established an International Advisory Council to advise on political, economic and social trends and events. Members are leaders of broad experience from various walks of life in a number of countries. The Council met twice during the year under the chairmanship of the Honourable Allan J. MacEachen, P.C.

The Council has, in its first year, already made a notable contribution. Its basic focus was upon the prospects for world economic and political stability. Issues discussed in detail include growth prospects in industrialized and developing countries, changing trade patterns and the progress of bilateral and multilateral trade negotiations, and the impact of international political developments upon individual countries and on the world economy.

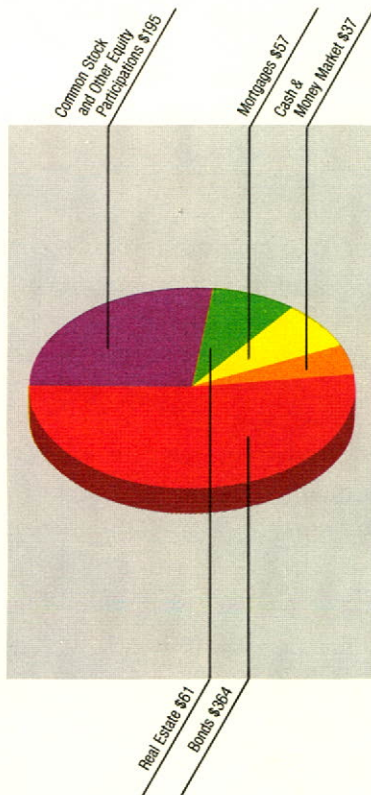
The Bank Family

During the year, the Bank issued a formal statement reaffirming its commitment to the many people it serves — its customers, employees, shareholders and the community at large. This statement, which reflects Bank tradition, is reprinted on page 24.

Fair and competitive compensation is a prerequisite for attracting, and retaining, top-notch people. Important steps were taken during the year to establish a more consistent range of benefits at all levels from clerical to senior executive. Pay levels were also increased in 1986, and pension benefits were improved. An Employee Assistance Program was introduced which provides professional counselling for family, marital and other personal matters.

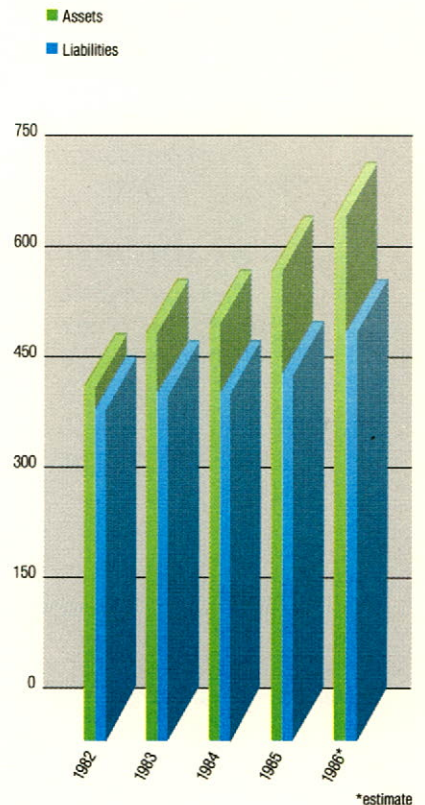
Pension Fund Society

(Market value of investment portfolio — \$ in millions)



Pension Fund Society

(Assets at market value and actuarial liabilities — \$ in millions)



A Commitment to People: The Bank of Montreal Tradition

A commitment to people – customers, employees, shareholders and neighbours – has been a cornerstone of our reputation since Bank of Montreal opened its doors as Canada's first permanent financial institution in 1817.

While the Bank has changed dramatically in the intervening years, its commitment to its own people and those it serves has remained constant. Our founders' commitment to ethical business practice, high professional standards and responsible conduct has also endured. Together these principles have guided us through more than a century-and-a-half of growth and expansion. Today, as in the past,



We are committed to our customers.

Every individual with whom we deal is respected, fairly treated and served to the best of our ability. In upholding the public trust vested in us, we will protect our customers' deposits and honour their privacy.



We are committed to our employees.

They are special. Their loyalty is prized as are their skills and experience. We are dedicated to their personal and professional development and well-being. We support equal opportunity and advancement in accordance with ability for all staff.



We are committed to our shareholders.

We have a duty to our shareholders to optimize the return on their investment, and through prudent management to maintain the continued prosperity of the Bank.



We are committed to the communities where we live and work.

We have traditionally observed the responsibilities of corporate citizenship, supporting charities, cultural programs, civic projects, research and education. Our staff voluntarily contribute time and talent to community activities.



We are proud of our traditions and our place in history.

From our predecessors we inherit an institution of stability, strength and character. On this foundation we can build confidently for the future.



Training has been directed to the skills needed to serve customers and supervise staff. A new three-tiered curriculum has been tailored to first-time supervisors, managers and senior managers. New courses include professional sales training, product training covering personal deposit services and a one-week program focusing on sophisticated Treasury products.

Pensions

Bank of Montreal's pension plans, excluding Harris Bankcorp, Inc., cover 23,310 current employees, and pay benefits to 4,226 retirees. Roughly 98% of covered employees are members of the Pension Fund Society, with the remainder covered by separate plans.

At October 31, 1986, total Pension Fund Society assets had a market value of \$714 million, compared with estimated liabilities of \$555 million. Bank policy is to maintain the surplus as a buffer against possible decreases in asset values and other contingencies.

Pension activities are organized to ensure sound financial control. Investment policy stresses a conservative mix of high quality assets. The asset mix and funded status of the plans, and the performance of investment managers, are reviewed regularly.

Assets are carried at market value and accounted for in accordance with recently issued guidelines of the Canadian Institute of Chartered Accountants. While most assets are in marketable securities, which have a readily determinable value, about 8% are in mortgages and 9% in real estate investments. Mortgage assets are valued at prevailing market yields, and the value of directly-held real estate properties is determined at each year-end based on reviews by the Bank's Real Estate Division and external consultants. As a further safeguard, properties are appraised by external appraisers every third year.

Valuation of plan liabilities is carried out annually by the consulting actuary. A Pension Advisory Committee, which includes six members of the Bank's Board, meets semi-annually to advise on plan design and on the management of investments.

The Bank in the Community

All donations to charitable organizations demand prudent consideration. The Bank can often simultaneously be a good corporate citizen and advance its business objectives.

The Donations Policy was described in last year's annual report. Bank of Montreal gives financial support "to eligible and worthy causes, institutions or organizations whose work benefits the community at the local, regional or national level and also in foreign countries where the Bank has significant branch offices or subsidiaries."

The largest portion of the Bank's donations budget is devoted to United Way agencies and to community service organizations such as Big Brothers, Boy Scouts of Canada, Junior Achievement and YM/YWCAs.

In higher education, the Bank contributed to the capital funding campaigns of universities across Canada. Through its Matching Gift Program, it supplemented donations made by staff and directors to universities in Canada and the United States.

Across Canada, the Bank contributed to hospitals and to organizations engaged in vital research into diabetes, heart disease, cancer and other illnesses.

The Bank last year participated in "City Shapes", a unique celebration of the City of Vancouver's centennial by the Sculptors' Society of British Columbia. "The Builders", a sculpture by Canadian artist B. Joyce McDonald, was the Bank's gift to Vancouver. It is now installed in Vancouver's Discovery Park. The Bank also co-sponsored a

competition for the creation of a heroic-size sculpture in Calgary's Stampede Park to honor the Alberta farm family. The sculpture, which celebrates 100 years' service to Albertans by the Calgary Exhibition and Stampede and by the Bank, will be unveiled in 1987.

The Bank continues to be a supporter of equestrian sports, its contributions helping to raise Canada's already high standard of performance which has earned international renown. Nations' Cup events are the world's most prestigious international equestrian events for national teams. There are eighteen Nations' Cup events in the world, four of which are held in North America. These are all sponsored by Bank of Montreal: at Spruce Meadows near Calgary, The Royal Agricultural Winter Fair in Toronto and, for the first time in 1986, the Washington International Horse Show (with Harris Bankcorp, Inc.) and the National Horse Show in New York.

The Bank actively supports Canadian cultural institutions. It was the principal corporate sponsor of the Montreal Symphony Orchestra's critically acclaimed tour of 10 United States cities last spring. In late 1987, the Bank will sponsor a European tour by the Orchestra. Such tours allow Canadian musical excellence to be demonstrated worldwide while providing an opportunity for bankers to meet business leaders in major centres abroad. In 1986 the Bank also contributed to the Vancouver Symphony Orchestra, the Royal Winnipeg Ballet, the Canadian Opera Company, the Toronto Symphony Orchestra and the National Ballet of Canada. Support was given to such performing arts groups as Halifax's Neptune Theatre, Niagara-on-the-Lake's Shaw Festival and the Stratford Festival, and to major museums and galleries around the country, such as the Art Gallery at Harbourfront in Toronto.

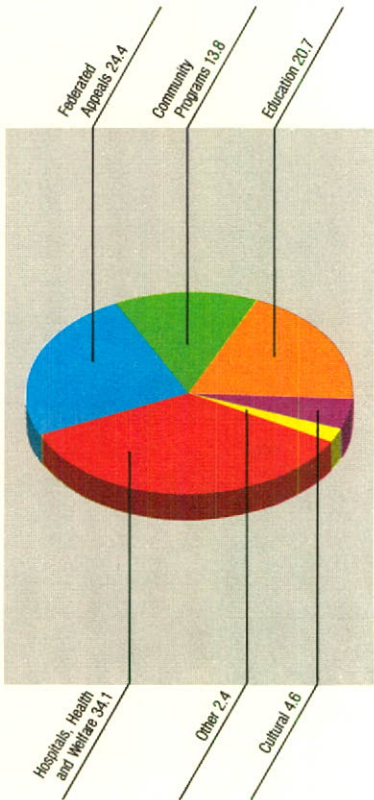
Corporate sponsorships and donations are only one part of the Bank's contribution to community life.

Employees in Canada, the United States and around the world support a wide range of charities and community activities. They donate their own time, money and effort.

Examples reflect the diversity of Bank staff. Bank people are volunteers with hospitals and women's shelters, work with youth groups such as local amateur hockey and Scouts and donate many hours to fund-raising efforts and administration work for cultural and community service groups. They organize charity drives, and they contribute generously.

In all their endeavors, they bring credit to themselves and to the Bank.

Allocation of Bank Donations
(%)

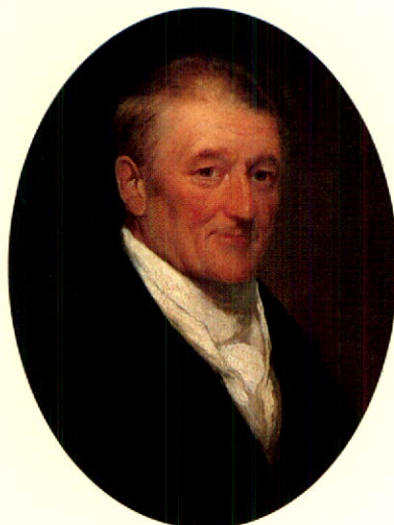


*"So lofty the Hall, so dim the Light / The Ceiling is almost out
of Sight / So still, so calm it is, they say / That at Times the
Folk from across the Way / By accident wander in to pray."
— from "Meet Mr. Wegg, Banker" by Stephen Leacock*
Montreal Main Branch and the église Notre-Dame, each a
splendid example of classic architecture, face one another across
historic Place d'Armes.*



Molson's 200th Anniversary

On July 28, 1786 John Molson entered into his diary the words "This day bought eight bushels of barley. My commencement to the grand stage of the world." Thirty-one years later, the Montreal Bank began operations a short distance away. Over the years, the oldest brewery in North America and the first bank in Canada have been closely related: as banker and client, as competitors and as members of the business community supporting the growth of this country.



John Molson (1763-1836) was 22 years old when he began his brewery in 1786. Forty years later he was elected President of Bank of Montreal. His business acumen was well respected throughout Lower and Upper Canada. During his four-year term, our reserve account increased eightfold and dividends were enlarged.

The Molsons had long engaged in banking as an adjunct to their main business. They had, for instance, issued their own notes and currency when the colonial authorities suspended specie payments in 1837. John Molson Jr. (right) and his brother William resigned as Bank of Montreal directors when the Molsons Bank was established in 1853.



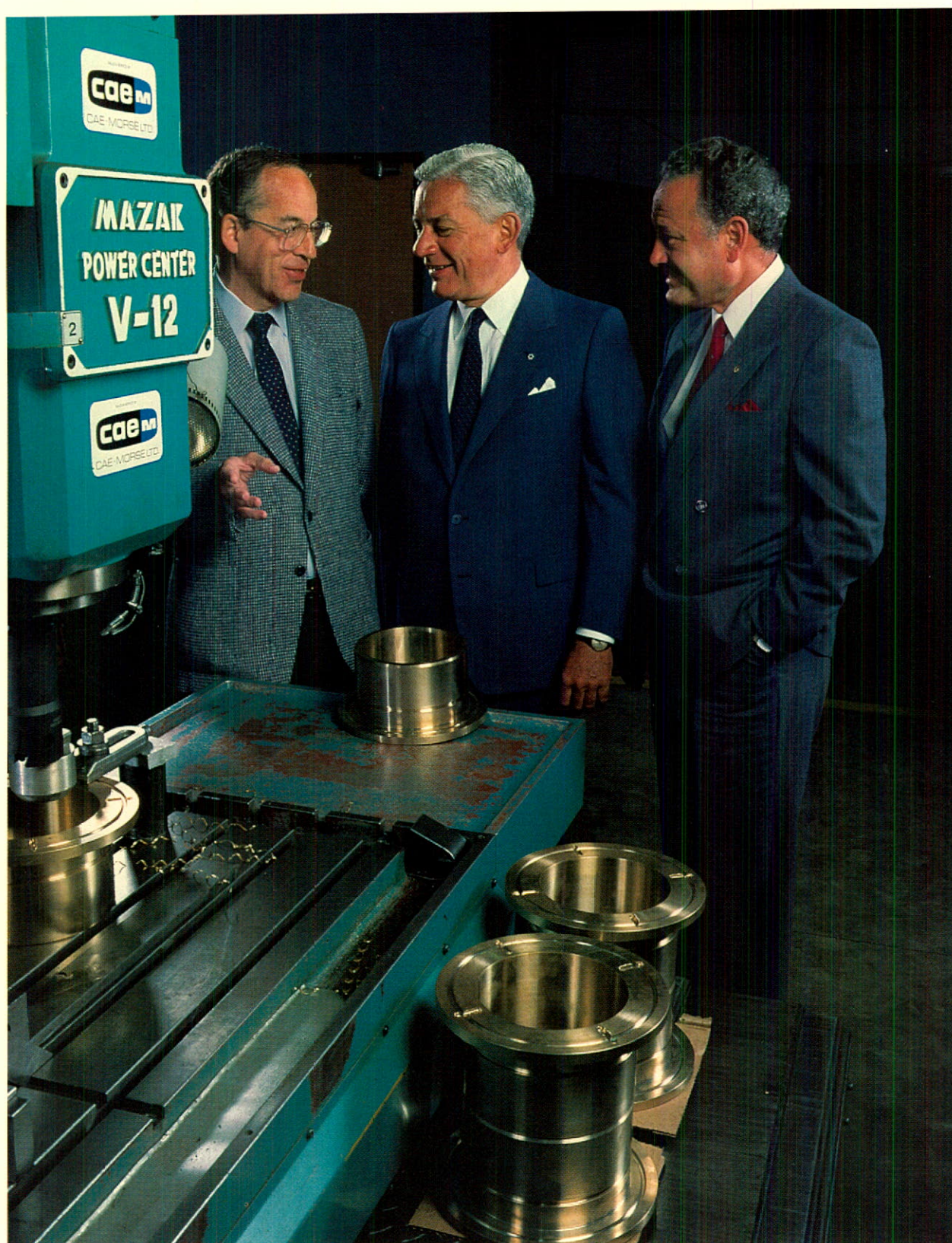
The Molsons Bank focus on safety and soundness stood it well for some seventy years. In January 1925, with 125 branches and assets of \$68 million, it merged with Bank of Montreal. F.W. Molson, last President of Molsons Bank and a principal architect of the merger, in 1927 joined his cousin, Col. Herbert Molson (left), on Bank of Montreal's board.

The key to our relationship has been people. Members of the Molson family have at various times been shareholders, officers and directors of the Bank. We in turn have been proud to be banker to the Molson Companies. From the first brewery operations in Montreal to today's diversified Molson Companies Limited, the family of John Molson have contributed generously to Canadian history and life: in business, in public and community service, in peace and in war. We salute the 200th anniversary of this leading Canadian institution.



In the boardroom of the historic Molsons Bank building (now a Bank of Montreal office) in Montreal, Bank Chairman William D. Mulholland (centre) congratulates Senator Hartland de M. Molson (left) and Eric H. Molson (right), Master Brewer and Deputy Chairman of the Molson Companies Limited, on the occasion of the Molsons' bicentennial celebrations. They are standing beneath a portrait of William Molson, who, like his father John Sr., understood the importance of strength and integrity in banking and in business. The Molsons have maintained their involvement in banking through to the present day: Senator Molson was a director of Bank of Montreal for 26 years, and Eric Molson has been nominated for election to the board at the forthcoming Annual General Meeting.

President Grant L. Reuber (centre) calls on Jean M. Perreault (left), President of Lefebvre Frères Limitée, a manufacturer of industrial machinery in east-end Montreal. They are joined by Account Manager Jean Sislian (right). A Bank customer since 1954, Lefebvre is a contractor for the Bécancour aluminum smelter in Quebec as well as for the province's pulp and paper industry.



Western Manitoba Broadcasters Limited has been a Bank of Montreal customer since the company was founded in 1948. Stuart Craig (right), President and owner, meets with Account Manager Barry Meadows (left) in the control room of CKX Radio and Television in Brandon. This year the Bank provided financing for the purchase of the company's fourth television service within Manitoba. Mr. Craig is a member of the Bank's Business Advisory Panel.



The Senicki family is one of many thousands who have taken advantage of the Bank's flexible, customer-oriented mortgage plans. Ron and Charlotte are talking to Lori Miscevitich (left), Mortgage Development Officer, as Carly (11) and Tara (10) play in front of their new home in Burlington, Ontario. The Senickis moved from Manitoba when Ron took up new responsibilities with his company in the Toronto area. The Bank's fast mortgage application and approval process were particularly helpful to them.



Beaver Lumber Company Limited has a close relationship with Bank of Montreal, as does its parent, the Molson Companies Limited. Molson President and Chief Executive Officer John P. Rogers (right), Beaver Lumber President John S. Lacey (left) and Bank Vice-President George C. Strachan (centre) are discussing a new on-line system installed by the Bank which allows computer authorization for credit card sales in Beaver Lumber stores nationwide, as well as the electronic capture of sales transactions.



Chairman William D. Mulholland visits with New York Times Company Vice-Chairman and Director Sydney Gruson (left), Senior Vice President and Chief Financial Officer David L. Gorham (second from right) and Treasurer Denise Fletcher (right). Bank of Montreal acts as agent bank for the company, a major force in the communications industry with holdings including daily and weekly newspapers, magazines, television and radio stations and newsprint mills. Canada, the world's largest exporter of pulp and paper products, supplies newsprint for the Times.



Relationship management is a vital component of Harris Bankcorp's corporate banking strategy. Harris Chairman and Chief Executive Officer B. Kenneth West (standing) and Vice President and Senior Relationship Manager Sharron R. Walsh pay a visit to the Kellogg Company's new world headquarters in Battle Creek, Michigan. They are meeting with Kellogg Vice President and Treasurer John R. Hinton (left) and Senior Vice President Finance Louis R. Somers (right).



George E. Neal (centre), Capital Markets Group Executive Vice-President, and C. Michael Stuart (left), Managing Director of Montreal Australia Limited, meet with Allan Johnstone, Vice President Finance, CRA Limited, Australia's largest mining, exploration and development company. During 1986 Bank of Montreal was appointed co-lead manager and issuing and paying agent in the securitization of debt for the Blair Athol Coal Project.



Montreal Expos André Dawson hits a home run at historic Wrigley Field in Chicago. When the Expos square off against the Chicago Cubs, Bank of Montreal cheers for both teams. The Bank provides services to the Expos and to the Chicago-based Tribune Company, which owns the Cubs.



The Montreal Symphony Orchestra rehearses in the église de St. Eustache in Quebec. Bank of Montreal is the principal sponsor of this world-renowned symphony, and in 1986 supported the MSO's highly successful United States tour. The church, which provides an excellent acoustic environment, is used by the MSO for recording.



TABLE OF CONTENTS

28/Introduction

30/Summary

31/Relative Contribution of Bank of Montreal and Harris Bankcorp Inc.

32/Income Statement

Net Interest Income and Spread

Provision for Loan Losses and

Loan Loss Experience

Other Operating Income

Non-Interest Expense

Income and Capital Taxes

38/Balance Sheet

Liquidity, Loans, Deposits & Average Assets

Non-Performing Loans Net of Reservations for Losses

Capital Funds

The purpose of this section is to provide an analysis of the major factors that affected the financial performance of the Bank in 1986.

For analytical purposes the Bank's results are segmented to separate the results of the Bank's U.S. subsidiary, Harris Bankcorp Inc. ("Harris"). Bank of Montreal excluding the impact of Harris is referred to throughout this section as the "Parent Bank".

Harris was acquired on September 4, 1984 and therefore the 1984 results included two months of Harris' income and expenses. Subsequently, results are included for a full year. Because of the substantial impact of the Harris acquisition, year over year comparisons and longer term analyses show significant variances which are more readily understood by a separate review of the Parent Bank and Harris results.

In order to more fully understand the financial results of a bank, certain terminology and accounting methods need to be explained. In particular, clarification of the concept of the *taxable equivalent adjustment* and the method of accounting for loan losses will assist the reader in understanding this section.

Taxable Equivalent Adjustment

The taxable equivalent adjustment is made to increase net interest income and income taxes to recognize the tax-exempt nature of interest income from small business development bonds, income debentures, term preferred shares and similar instruments. As a result of holding such tax-exempt instruments, both net interest income and the provision for income tax of the Bank are less than the amounts which would result if the income from these securities was taxable. The taxable equivalent adjustment increases interest income and taxes to such greater amounts to more clearly reflect the

economic yield on these instruments. There is no effect on the Bank's net income. The amounts of these adjustments in the last five years are:

Year	\$Millions
1982	220
1983	155
1984	127
1985	175
1986	193

Accounting for Loan Losses

Loan loss reservations are comprised of specific and general reservations for possible losses on loans and are deducted from loan balances shown on the balance sheet. They are not included in determining the equity capital of the Bank. Loan loss reservations are intended to provide against the possibility that loan principal will not be repaid.

Loan loss experience is the current year's loss experience and is comprised of net new reservations made during the year less principal recovered on loans previously written off.

Provision for loan losses is the amount deducted from income determined in accordance with an averaging formula mandated by the Minister of Finance. Essentially it is the average ratio of loan loss experience to eligible loans for the most recent five years, applied to total eligible loans at September 30th of the current year.

Eligible loans as defined by the Minister of Finance basically includes all loans and securities (other than those guaranteed by the government of Canada or a province) as well as customer acceptances, guarantees and letters of credit.

The amount charged to income in respect of loan losses is the provision for loan losses which may be greater or less than the actual loan loss experience for the year.

The difference between the loan loss experience and the provision for loan losses is charged or credited, as the case may be, directly to the appropriations for contingencies, one of the capital accounts on the balance sheet of the Bank.

As a result of using the averaging formula described above, the reported results of Canadian banks are not comparable over the short term to other international banks whose jurisdictions normally require an equivalent to the loan loss experience to be charged against earnings.

The averaging formula tends to smooth the year-over-year changes to the provision. As a result the Bank's provision for loan losses differs at times quite significantly from the actual loan loss experience. To eliminate this effect, there is reference in various parts of the Management Analysis to income determined on the *loan loss experience basis* which represents a restatement of reported net income for the year obtained by substituting the actual loan loss experience for the provision for loan losses in the income statement (and adjusting for any tax effect).

In 1986 Bank of Montreal reported consolidated net income of \$353 million compared with \$339 million in 1985, an increase of 4%. On a loan loss experience basis, consolidated net income was \$311 million, \$80 million below the 1985 results.

Of particular significance was the increase in the provision for loan losses. During 1986, the Bank set aside some \$264 million in reservations against loan balances whose values have been adversely affected by the decline in oil prices. This accounts for almost all of the increase in loan loss experience and some 60% of the increase in the provision for loan losses. Other factors were the application of the averaging formula and the growth in eligible loans.

Net interest income increased from \$1,965 million to \$2,081 million, primarily because of a 9% increase in average assets. Spreads declined by 7 basis points due to foregone interest on petroleum sector loans and because assets increased mostly in loans and securities which carry below average spreads.

Other operating income increased by \$137 million over 1985, about three quarters of which is accounted for by the Parent Bank. The major contributors to this increase were activity fees, foreign exchange revenue and MasterCard merchant discounts.

Non-interest expenses increased by \$148 million or 8%. The Parent Bank rate of growth was 5% caused in large part by events beyond the control of the Bank such as the substantial increases in capital taxes and deposit insurance premiums. The growth in Harris' expenses was for the most part caused by increased employee expenses and the expansion of Harris' operations, including the acquisition, late in fiscal 1985, of First National Bank of Barrington.

Average assets have increased by \$7.3 billion. Loan growth was the principal factor with the personal sector showing the highest increases. The Bank continues to place strong emphasis on the enforcement of credit standards in the commercial and

consumer lending process, the success of which can be seen from the steady decline in the Bank's non-performing loans since 1983, a process temporarily reversed in 1986 due to the problems in the petroleum sector. Liquid assets increased by \$2.6 billion over the year to reach \$24.0 billion at October 31, 1986.

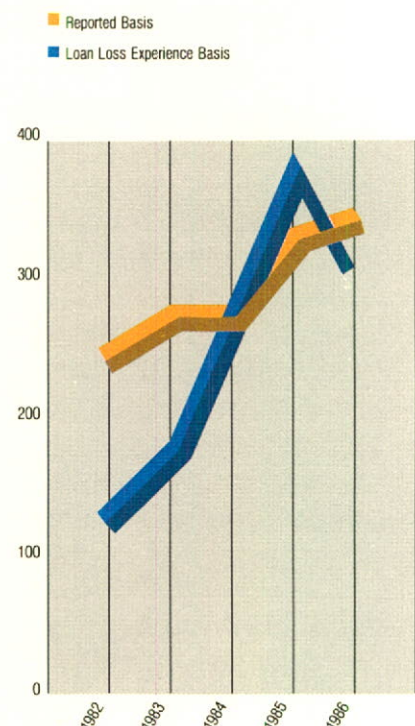
The consolidated return on average assets for the year was 0.41% as compared with 0.43% last year. On a loan loss experience basis the return was 0.36%, down from the 0.49% recorded last year due to the substantial reservations set aside against petroleum industry risks.

Net Income

(\$ in millions)	1982	1983	1984	1985	1986
Reported Basis	257	283	283	339	353
Loan Loss Experience Basis	141	185	289	391	311

Net Income

(\$ in millions)



Relative Contribution of Bank of Montreal and Harris Bankcorp, Inc.

As mentioned in the Introduction, the analysis which follows segments the results of the Bank between the Bank's U.S. subsidiary, Harris Bankcorp Inc., and the remainder of the Bank referred to as the "Parent Bank".

In order to understand the consolidation of Harris and the Parent Bank, the table below shows the summary income statement, average assets and return on average assets for the Parent Bank and Harris for 1986 and the adjustments required to reconcile to the reported results on a consolidated basis.

The major component of the combination adjustments is net interest income which reflects the imputed cost of funding the investment in Harris.

For 1986, on average, 67% of the cost of the Harris acquisition was deemed to have been funded by additional equity capital and 33% by interest bearing funds. The interest cost imputed to the latter, with related tax adjustments, is set off against the earnings flow from Harris in determining its net contribution to the consolidated earnings of the Bank.

The remaining components of the combination adjustments reflect the amortization of the amount by which the purchase price of the Harris acquisition exceeded its net asset value.

Relative Contribution of Parent Bank and Harris (Loan Loss Experience Basis) 1986

(\$ in millions)	Parent Bank	Harris	Combination Adjustments	Bank of Montreal Consolidated
Income				
Net Interest Income*	1,841.5	464.7	(32.2)	2,274.0
Loan Loss Experience	549.0	55.7	—	604.7
	1,292.5	409.0	(32.2)	1,669.3
Other Operating Income	570.1	248.2	0.6	818.9
Non-Interest Expense	1,452.0	466.6	16.9	1,935.5
	410.6	190.6	(48.5)	552.7
Provision for Income Taxes*	168.0	94.1	(24.4)	237.7
Minority Interest	4.4	—	—	4.4
Net Income	238.2	96.5	(24.1)	310.6
Average Assets (\$ in billions)	73.5	13.1	0.2	86.8
Return on Average Assets (percent)	0.32	0.74	—	0.36

*Tax equivalent basis

Net Interest Income and Spread

Net interest income is the difference between interest earned on loans and securities and interest paid on deposits and debentures. For the purpose of analysis it is adjusted to a tax equivalent basis. Net interest spread is the net interest income adjusted to a taxable equivalent basis divided by the average of month-end total assets. The Bank's consolidated tax equivalent net interest income in 1986 amounted to \$2,274 million, an increase of \$134 million from the previous year.

Parent Bank spread declined from 2.66% to 2.51% caused by four main factors. First, in common with the industry, deposit costs relative to the prime rate have continued to increase. Secondly, the yield on the Bank's liquidity portfolio was lower than in 1985. The first half of 1985 produced steadily declining interest rates in Canada while in the first half of 1986, this trend was reversed. As the Bank's liquidity portfolio is generally funded by variable rate deposits, yields tend to be improved in a declining rate environment, thus gains in spread during 1985 were not repeated in 1986. Thirdly, the increased level of non-performing loans in the petroleum sector has meant that approximately \$40 million of loan interest has been foregone. Finally, earnings from International Money Market Operations were reduced in 1986 due to less favourable trading conditions.

Harris net interest spread increased from 3.25% to 3.55% due to an increasing proportion of higher

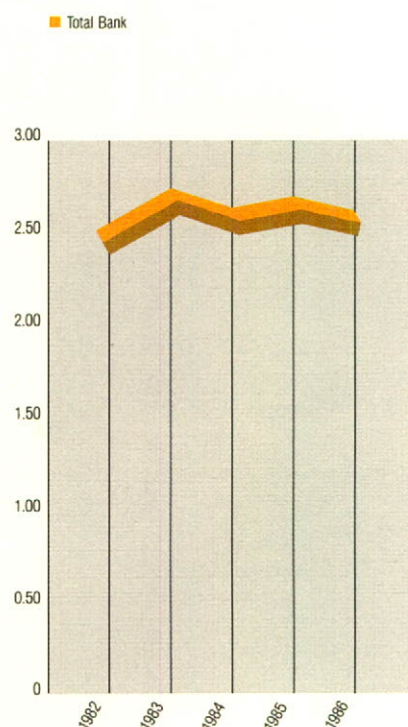
yielding assets and non-interest bearing deposits.

To the extent that interest income and expense do not respond equally to changes in the interest rates, net interest margins are affected. For example, if the Bank's loans or securities are less sensitive to a rise in interest rates than the liabilities, such as customer deposits, which fund those assets, then a rise in interest rates will reduce margins until the assets are renewed at the increased rates. When interest rates are falling in such an environment the reverse is true; margins will temporarily increase.

The policy of the Bank is to minimize this risk by matching the terms of liabilities and assets within approved limits, so that net income will not be unduly sensitive to interest rate movements. These positions are reviewed regularly by the Bank's Funds Management Committee.

Net Interest Spread-Tax Equivalent Basis

(As a % of average assets)



Net Interest Income-Tax Equivalent Basis

(\$ in millions)	1982	1983	1984	1985	1986
Total Bank NII as reported	1,370	1,582	1,626	1,965	2,081
Taxable equivalent adjustment	220	155	127	175	193
NII tax equivalent basis	1,590	1,737	1,753	2,140	2,274

Net Interest Spread-Tax Equivalent Basis

(As a % of average assets)	1982	1983	1984	1985	1986
Parent Bank	2.54	2.73	2.63	2.66	2.51
Harris			2.69*	3.25	3.55
Total Bank	2.54	2.73	2.63*	2.69	2.62

*The ratio for Harris has been restated to reflect net interest income for the full year. The Total Bank ratio reflects the inclusion of Harris for only the two months following acquisition.

Provision for Loan Losses and Loan Loss Experience

Loan Loss Experience

The Bank's consolidated loan loss experience in 1986 amounted to \$605 million, an increase of \$275 million from 1985. For the Parent Bank, loan loss experience for the year was \$549 million, an increase of \$259 million over 1985.

The primary cause of this increase was the precipitous decline in petroleum prices and the decision to provide new reservations of approximately \$264 million against petroleum related assets, of which \$251 million relates to the Parent Bank. Without those additional reservations, loan loss experience would have remained at the level achieved in 1985.

As a result of the increased petroleum provision, the Bank's consolidated ratio of loan loss experience to eligible loans in 1986 was 98 basis points, up 40 basis points from 1985. It is important to understand that these loan losses are potential losses and not realized losses.

The decline in revenues for oil producers has, in many cases, severely restricted operations and impaired their ability to service debt commitments.

The Bank's total petroleum industry outstanding loans amount to approximately \$5.5 billion. Of this, less than half is in the production sector, which is the sector most directly linked to declining oil prices. The service sector, the most troubled industry sector, is less than 2% of the total and the Bank is

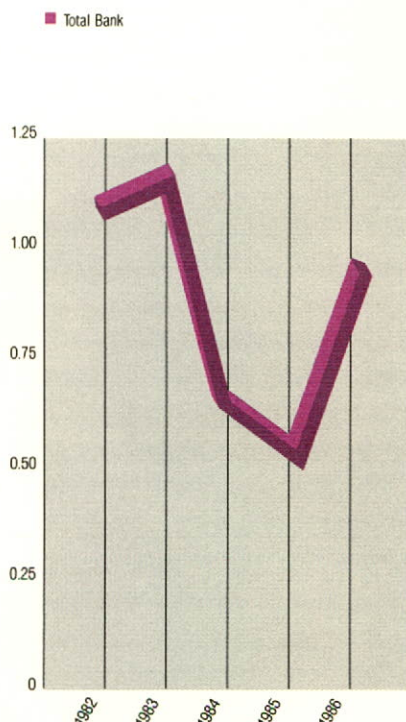
well secured. The remaining 50% of the portfolio is in the transmission and large integrated sectors, which are relatively stable, and in the refinery and petro-chemical sectors, which benefit from lower oil prices.

During the year, the Bank's engineering staff reviewed the estimates of economically recoverable oil and gas reserves of petroleum industry accounts based upon oil prices of U.S. \$15 per barrel without any provision for escalation. In a number of instances, these reviews led to reduction in those estimates and, where appropriate, to increased loan reservations.

Almost all of the Bank's additional petroleum sector reservations in 1986 relate to the production sector.

Loan Loss Experience

(As a % of eligible loans)



Loan Loss Experience

(As a % of eligible loans)

	1982	1983	1984	1985	1986
Parent Bank	1.13	1.19	0.77	0.59	1.03
Harris			0.34*	0.51	0.64
Total Bank	1.13	1.19	0.68*	0.58	0.98

*The ratio for Harris has been restated to reflect loss experience for the full year. The Total Bank ratio reflects the inclusion of Harris for only the two months following acquisition.

Provision for Loan Losses and Loan Loss Experience

At the end of October 1986, oil prices had steadied at around U.S. \$15 and this critical assumption was unchanged. The weighted average price of oil for the year is estimated to have been approximately U.S. \$15.

The remaining loan loss experience in 1986 for the Parent Bank was \$298 million, of which almost half consisted of general reservations set aside against sovereign debt, the balance consisting of specific reservations in respect of the remainder of the Bank's loan portfolio.

Provision for Loan Losses

The effect of the formula prescribed by the Minister of Finance is to average the loan loss experience over five years. Thus the impact on net income of changes in loan loss experience is delayed.

In 1986 the Bank's consolidated loan loss experience was \$84.1 million higher than the provision for loan losses.

Loan Loss Experience & Provision for Loan Losses

(\$ in millions)	1982	1983	1984	1985	1986
Loan loss experience	550	551	365	330	605
Provision for loan losses	319	361	375	428	521

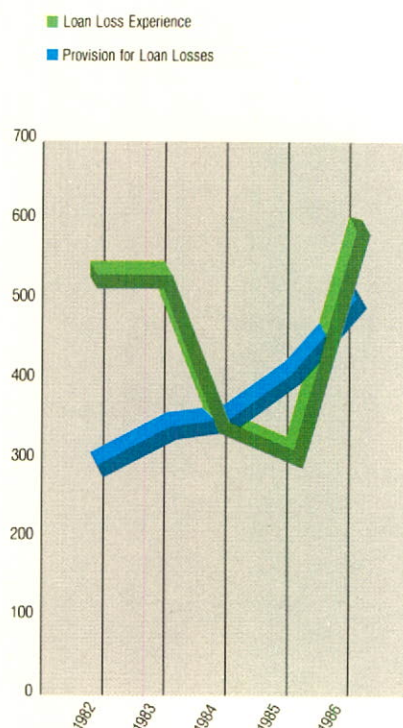
An important element in the calculation of the provision is the total of eligible loans at September 30th each year. On that date in 1986, the Bank's total of eligible loans had reached \$62 billion, an increase of \$5 billion from 1985.

Eligible Loans

(\$ in millions)	1982	1983	1984	1985	1986
Parent Bank	48,598	46,160	46,772	49,154	53,278
Harris			7,229	7,827	8,668
Total Bank	48,598	46,160	54,001	56,981	61,946

Loan Loss Experience & Provision for Loan Losses

(\$ in millions)



Other Operating Income

Other operating income consists of service charges, charge card income, most loan administration fees, income from foreign exchange, trust income and all other income which is not dividend or interest income.

In 1986 such income on a consolidated basis was \$819 million, an increase of \$137 million from last year. The 1986 increase for the Parent Bank was \$101 million with Harris accounting for the remainder. Growth occurred in all major categories.

Service charge income rose by \$50 million reflecting continued increases in the volume of transactions processed by the Bank. Similarly, principally due to the increasing use of MasterCard and the increasing number of merchants accepting the card, charge card income increased by \$24 million. Also contributing to that growth was the expansion of MasterCard Gold Card introduced in 1985. Loan administration fees grew by \$20 million or 17% and foreign exchange by \$15 million or 19%.

Trust income, a major activity for Harris, was \$105 million in 1986, up \$20 million or 24% over the previous year.

The category of "Other" which contains such items as safekeeping fees and commissions grew by \$8 million or 9%, a major factor being the high volume of Canada Savings Bonds purchased through the Bank.

Other Operating Income

(\$ in millions)	1982	1983	1984	1985	1986
Service charges	109	128	148	185	235
Charge card	65	66	78	130	154
Loan fees	77	93	87	114	134
Foreign exchange	34	46	50	77	92
Trust income	—	—	14	85	105
Non-recurring gains	—	—	43	—	—
Other	66	78	79	91	99
Total Bank	351	411	499	682	819

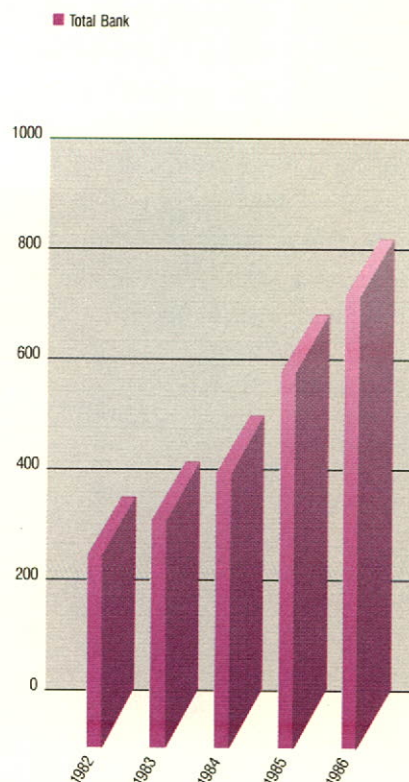
Other Operating Income

(As a % of average assets)	1982	1983	1984	1985	1986
Parent Bank	0.56	0.65	0.73	0.69	0.78
Harris			1.42*	1.80	1.89
Total Bank	0.56	0.65	0.75*	0.86	0.94

*The ratio for Harris has been restated to reflect other operating income for the full year. The Total Bank ratio reflects the inclusion of Harris for only the two months following acquisition.

Other Operating Income

(\$ in millions)



Non-Interest Expense

Non-interest expense consists of employee costs, premises and equipment costs and all other operating expenses. In total, these expenses amounted to \$1,935 million in 1986, an increase of \$148 million or 8% from last year.

Employee expenses for the Parent Bank were \$803 million, \$26 million or 3% higher than last year, attributable primarily to salary increases during the year.

Parent Bank premises, equipment and computer costs increased from \$294 million in 1985 to \$307 million in 1986, an increase of 4%. Most of this increase is in computer expenses which principally comprise depreciation and rental of computer equipment and the cost of data communication. These expenses do not reflect all technology-related expenses of the Bank, some of which are included in salaries and in premises and equipment.

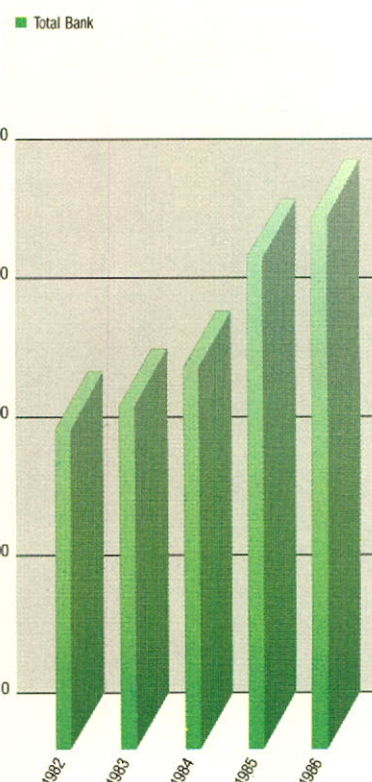
The category of "Other expenses" contains such items as travel, advertising, communications, and federal and provincial capital taxes. For the Parent Bank, this category has increased by \$40 million or 13% to \$342 million. Much of this disproportionate increase is attributable to the new federal capital tax introduced in 1986 and increased deposit insurance premiums. Without those additional levies, over which the Bank has no control, expenses in this category would have increased by only 2%.

In aggregate, the Parent Bank non-interest expense increased from 1985 by 6% whereas assets in that same period grew by 9%. As a result the Parent Bank's ratio of non-interest expense to average assets fell below 2% for the first time since 1983.

Conversely, the ratio of expenses to assets for Harris increased to 3.56%. This reflects an emphasis on activities (such as the trust business) which generate non-interest revenue rather than earning assets.

The absolute increase in Harris expenses was approximately \$70 million. About half of this is due to employee expense increases and the effect of currency translation. One-sixth is attributable to the inclusion throughout 1986 of First National Bank of Barrington, acquired in August 1985 with the remainder spread through other categories.

Non-Interest Expense
(\$ in millions)



Non-Interest Expense

(\$ in millions)	1982	1983	1984	1985	1986
Salaries and staff benefits	694	727	777	996	1,060
Premises and equipment	149	183	213	261	269
Computer	72	74	75	104	121
Other expenses	248	265	319	426	485
Total Bank	1,163	1,249	1,384	1,787	1,935

Non-Interest Expense

(As a % of average assets)	1982	1983	1984	1985	1986
Parent Bank	1.85	1.96	2.03	2.03	1.98
Harris			3.13*	3.36	3.56
Total Bank	1.85	1.96	2.07*	2.25	2.23

*The ratio for Harris has been restated to reflect non-interest expense for the full year. The Total Bank ratio reflects the inclusion of Harris for only the two months following acquisition.

Income and Capital Taxes

In 1986, the Bank's provision for income taxes was \$86.5 million, a decrease of \$1.1 million from 1985. Expressed as a percentage of income before taxes the provision was 19.5% in 1986, as compared with 20.3% in 1985.

This rate is less than the Canadian statutory marginal income tax rate of 49.6% applicable in 1986. This difference is primarily attributable to the income derived by the Bank from tax-exempt instruments, the existence of which reflects Government policy initiatives designed to aid various economic groups such as small business. In substance, the benefit to the Bank arising from the non-taxable status of such income is passed on to the issuers of these instruments in the form of reduced borrowing costs. The yield on these instruments is approximately one-half of that which would prevail on taxable obligations.

As previously explained, the taxable equivalent adjustment increases both net interest income and provision for income taxes to the amounts which would result if the income from these instruments were taxable. Restated on this basis, the provision for income taxes would have amounted to 43.9% of income before taxes in 1986.

The aggregate tax rate is also affected by the rates of foreign tax applicable to the income earned by foreign subsidiaries of the Bank. The combined effective tax rate on these earnings is lower than the Canadian statutory marginal income tax rate.

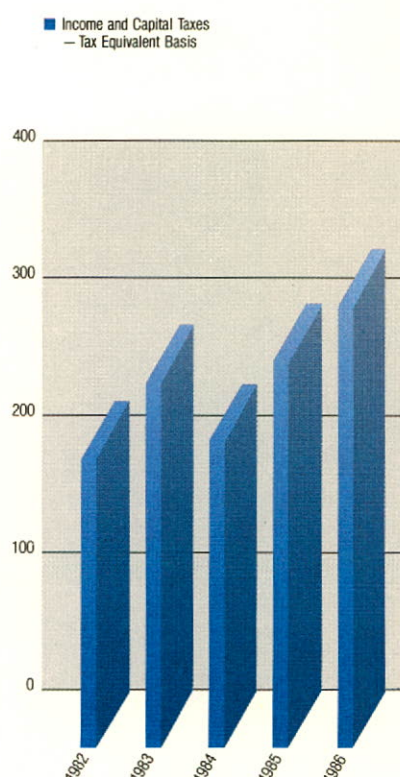
Income and Capital Taxes-Tax Equivalent Basis

(\$ in millions)	1982	1983	1984	1985	1986
Provision (recovery) for income taxes	(22)	96	79	88	87
Taxable equivalent adjustment	220	155	127	175	193
Capital taxes	13	15	17	19	40
Income and capital taxes on tax equivalent basis	211	266	223	282	320

Another element of taxation which is not included in the provision for income taxes is federal and provincial capital taxes which are treated as other non-interest expenses. In 1986, the amount of these taxes payable by the Bank was \$40 million compared with \$19 million in 1985.

In addition to direct taxes on income and capital, Canadian chartered banks, unlike trust companies and other financial institutions with which the Bank competes, are required under the Bank Act to deposit interest-free reserves with the Bank of Canada. The foregone interest on these reserves represents a significant cost to the Bank.

Income and Capital Taxes-Tax Equivalent Basis
(\$ in millions)



Liquidity, Loans, Deposits & Average Assets

Liquidity

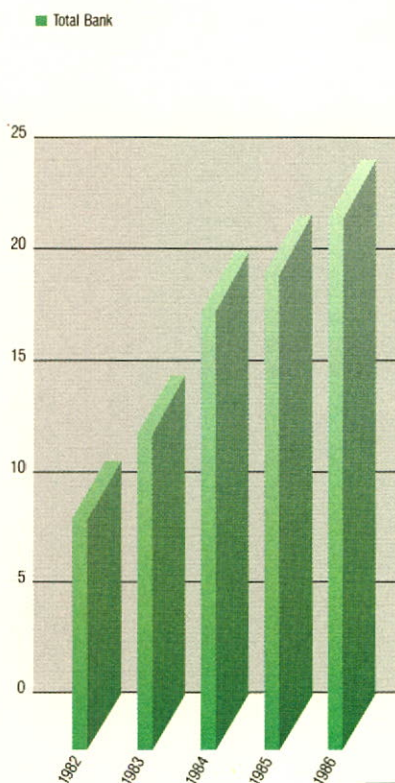
It is the policy of the Bank to maintain a consistently high level of liquid assets in both Canadian and U.S. dollars, which it holds in the form of cash resources, deposits with banks, liquid securities and day, call and short loans. At the end of fiscal 1986, the level of liquid assets had increased to \$24 billion, about \$2.6 billion higher than at the end of last year. Of the total, approximately \$2 billion must be maintained in order to meet Bank of Canada reserve requirements, about half of which is not interest-bearing.

Liquidity

(\$ in billions)	1982	1983	1984	1985	1986
Cash resources	1.1	1.4	2.0	2.4	2.2
Deposits with banks	6.4	6.9	11.3	10.3	12.3
Liquid securities	2.4	5.7	6.0	7.8	8.3
Day, call & short loans	0.5	0.3	0.6	0.9	1.2
Total	10.4	14.3	19.9	21.4	24.0

Liquidity

(\$ in billions)



A portion of the Bank's liquidity is maintained in deposits with other banks. These are marketable deposit instruments of first tier, internationally recognized banks which have the potential to generate substantial trading revenue as well as interest income.

The third element of liquidity is the Bank's holdings of Canadian and U.S. Government Treasury Bills. The fourth element, day, call and short loans, mainly comprises secured overnight advances to securities dealers.

Loans

The Bank's loan portfolio at October 31, 1986 amounted to \$54.5 billion. Loan growth for the Parent Bank in 1986 was approximately \$3.8 billion (9%), most of which was Canadian dollar loans. Average personal sector loans outstanding grew by 19% to reach \$14.3 billion by the year-end. Particularly strong growth was experienced in the home mortgage loan market. Harris' loan growth of \$0.7 billion was the principal source of growth in foreign currency loans.

The wide geographic diversification of the Bank's loan portfolio is shown in Note 5 to the financial statements.

The Bank's policy is to maintain geographic diversity and to spread portfolio risk among major sectors of economic activity.

Deposits

Total deposits at \$74.9 billion were 5% higher at October 31, 1986. For the Parent Bank, deposits reached \$63.5 billion, an increase of 5%. Almost half of these deposits represent personal deposits which increased by 8% in 1986. The remainder are deposits gathered to fund the Bank's loans and securities in other currencies which are increasingly being sourced directly rather than through the wholesale or interbank markets.

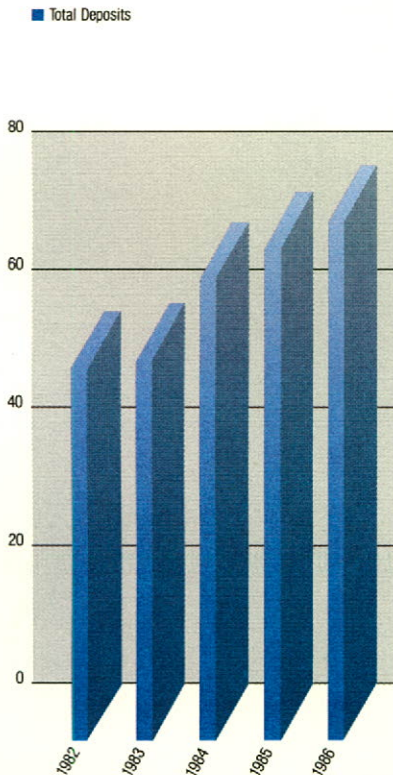
For Harris, deposits increased by \$0.7 billion to reach \$11.4 billion. Almost half of the increase was in non-interest bearing deposits.

Deposits

(\$ in billions)	1982	1983	1984	1985	1986
Demand	4.4	5.3	7.0	8.9	8.7
Notice	14.0	15.0	16.0	18.5	20.2
Term	35.5	35.0	43.7	44.0	46.0
Total	53.9	55.3	66.7	71.4	74.9

Deposits

(\$ in billions)



Bank policy is to match assets and liabilities in the 57 currencies in which the Bank's business is transacted. U.S. dollar loans are funded by an approximately equal amount of U.S. dollar deposits. Outside Canada, these deposits come primarily from commercial customers, governments and non-bank financial institutions.

Average Assets

The average of the month-end assets increased \$7.3 billion (9%) to \$86.8 billion. The Parent Bank's average assets increased by \$5.9 billion (9%); the Harris increase was \$1.4 billion (12%).

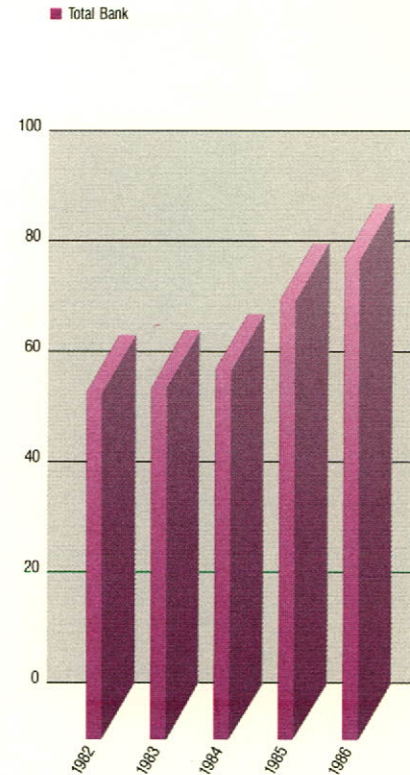
Average Assets

(\$ in billions)	1982	1983	1984	1985	1986
Parent Bank	62.8	63.7	65.0	67.8	73.7
Harris			10.9*	11.7	13.1
Total Bank	62.8	63.7	66.7*	79.5	86.8

*The average assets for Harris have been restated to reflect those for the full year. For the period from September 4, 1984 to October 31, 1984 the average assets were \$1.7 billion which is reflected in the average assets of Total Bank.

Average Assets

(\$ in billions)



Non-Performing Loans Net of Reservations for Losses

Non-performing loans, as defined by the Inspector General of Banks, are those loans and loan substitution securities which have been placed on a non-accrual basis under circumstances outlined in the section of this report entitled "Significant Accounting Policies and Procedures" and those loans which have been renegotiated at a reduced interest rate.

Loan loss reservations comprise specific and general reservations set aside against the possibility that loan principal will not be repaid.

Non-Performing Loans

During fiscal 1986 the Bank's level of total non-performing loans, net of reservations for losses increased from \$1.3 billion at year-end 1985 to \$2.0 billion at the end of 1986. This increase was entirely caused by the decision to place some \$1.1 billion of loans in the petroleum sector on non-accrual status. This measure was a direct result of the decline in oil prices at the beginning of 1986 and the assumption made by the Bank that prices will remain depressed for some time. Excluding the impact of the petroleum sector loans, the remainder of the Bank's non-performing loans continued to decline.

Reservations for Losses

The Bank continually reviews its loans and securities in order to assess whether any reservations for potential loan losses are required.

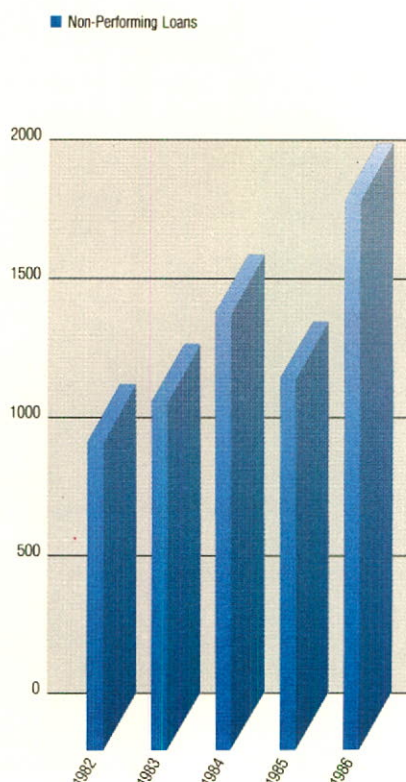
The Bank's credit review process is designed to ensure that recognition of potential losses takes place at the earliest opportunity. A key indicator of

the successful implementation of that process is the high yield which the Bank achieves on non-performing loans. In 1986, the yield (representing cash receipts less interest reversals) on non-performing loans was 7.6%. This compares with a weighted average prime rate on Canadian and U.S. dollar loan balances during the year of 8.9%.

In addition to the amounts set aside against normal commercial risks and petroleum risks the Bank has continued to set aside general reservations against balances outstanding to 32 countries specified by the Inspector General of Banks. At October 31, 1986, the Bank had set aside general and specific reservations amounting to 12.8% of all public, private and interbank indebtedness at risk in those countries. It is the Bank's intention to continue to add to these prudential reserves.

**Non-Performing Loans at Year End
Net of Reservations for Losses**

(\$ in millions)



**Non-Performing Loans at Year End
Net of Reservations for Losses**

	1982	1983	1984	1985	1986
Non-performing loans (\$ in millions)	1,124	1,262	1,593	1,337	1,995
As a % of eligible loans	2.31	2.73	2.95	2.35	3.22
Interest income on Non-performing loans (\$ in millions)	25	114	122	127	120

Capital Funds

The capital and contingency reserves shown on the Statement of Assets and Liabilities comprise funds invested by shareholders, retained earnings and appropriations for contingencies. Reservations for loan losses are not included in either capital or contingency reserves.

It is the Bank's policy to maintain adequate capital in support of its asset volumes and as required by various regulatory authorities.

At the end of the fiscal year, capital and contingency reserves were \$3.6 billion, an increase of \$193 million from a year ago. Total capital funds were \$5.1 billion at October 31, 1986, \$555 million higher than the previous year-end.

The expansion of the Bank's capital base in 1986 came primarily from retained earnings and proceeds from shareholder reinvestment plans.

In addition, on July 23, 1986, the Bank issued U.S.\$250 million in Series 10 debentures, the terms of which are detailed in Note 9 to the financial statements. Subsequently, part of the proceeds were used to refund U.S. \$100 million (principal amount) of Series 5 floating rate debentures which were called by the Bank for redemption on December 22, 1986.

Capital Funds

(\$ in millions)	1982	1983	1984	1985	1986
Bank debentures	726	728	1,065	1,100	1,462
Equity capital	2,316	2,388	2,946	3,452	3,645
Total capital funds	3,042	3,116	4,011	4,552	5,107

Capital Ratios

(percent)	1982	1983	1984	1985	1986
Ratio of total capital and contingency reserves to total assets	3.73	3.78	3.85	4.19	4.18
Ratio of total capital and contingency reserves and subordinated debt to total assets	4.90	4.93	5.24	5.52	5.86

The Bank's ratio of equity capital and contingency reserves to total assets was 4.18% at October 31, 1986 virtually unchanged from October 31, 1985.

In the United States, the regulatory definition of capital has several differences from that used in Canada. The major difference is that the U.S. definition permits the inclusion of provisions for credit losses calculated under U.S. regulations. In Canada, loan loss reservations are entirely excluded. This difference in methodology results in a lower capital ratio calculated in accordance with Canadian practice than would be the case in the United States.

Capital Funds

(\$ in millions)

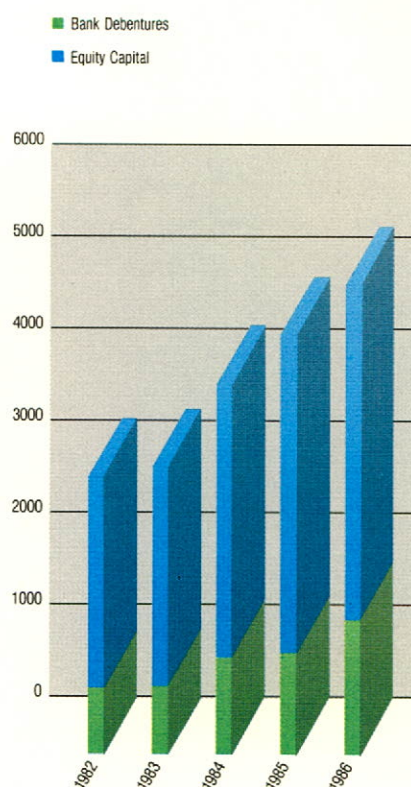


TABLE OF CONTENTS

44/ Annual Financial Statements

Consolidated Statement of Assets and Liabilities

Consolidated Statement of Income

Consolidated Statement of Appropriations for Contingencies

Consolidated Statement of Changes in Shareholders' Equity

Significant Accounting Policies and Practices

Notes to Consolidated Financial Statements

67/Statement of Management's Responsibility for Financial Data

68/Auditors' Report

Annual Financial Statements

Bank of Montreal

Consolidated Statement of Assets and Liabilities

As at October 31

(\$ in thousands)

Assets	1985	1986
Cash Resources		
Cash and deposits with Bank of Canada	\$ 936,836	\$ 1,105,573
Deposits with other banks	10,324,791	12,265,534
Cheques and other items in transit, net	1,474,270	1,142,854
	<u>12,735,897</u>	<u>14,513,961</u>
Securities Issued or Guaranteed by (note 1)		
Government of Canada	4,991,777	4,133,494
Provinces and municipal or school corporations	192,807	589,044
Other	5,339,723	5,802,286
	<u>10,524,307</u>	<u>10,524,824</u>
Loans (net of reservations for losses of \$1,585,584; 1985 — \$1,265,532)		
Day, call and short loans to investment dealers and brokers, secured	866,687	1,142,707
Banks	2,791,942	2,930,653
Mortgages	7,182,842	8,886,736
Other	41,124,746	41,510,461
	<u>51,966,217</u>	<u>54,470,557</u>
Other		
Customers' liability under acceptances	4,228,273	4,632,601
Land, buildings and equipment (note 3)	1,269,283	1,277,948
Other assets (note 4)	1,695,724	1,759,626
	<u>7,193,280</u>	<u>7,670,175</u>
Total Assets	\$82,419,701	\$87,179,517

Liabilities, Capital and Contingency Reserves	1985	1986
Deposits (note 6)		
Payable on demand	\$ 8,866,947	\$ 8,729,485
Payable after notice	18,552,738	20,131,834
Payable on a fixed date	43,968,351	46,015,077
	<u>71,388,036</u>	<u>74,876,396</u>
Other		
Acceptances	4,228,273	4,632,601
Liabilities of subsidiaries, other than deposits (note 7)	608,727	779,521
Other liabilities (note 8)	1,587,265	1,728,127
Minority interest	55,402	55,521
	<u>6,479,667</u>	<u>7,195,770</u>
Subordinated Debt		
Bank debentures (note 9)	1,099,521	1,462,482
Capital and Contingency Reserves (note 10)		
Appropriations for contingencies	457,101	459,464
Shareholders' equity		
Share capital (note 11)		
Preferred shares	650,079	650,079
Common shares	1,130,186	1,252,482
Retained earnings	1,215,111	1,282,844
	<u>3,452,477</u>	<u>3,644,869</u>
Total Liabilities, Capital and Contingency Reserves	\$82,419,701	\$87,179,517



William D. Mulholland
Chairman and
Chief Executive Officer



Grant L. Reuber
President and
Chief Operating Officer

Bank of Montreal

Consolidated Statement of Income

For the Year Ended October 31

(\$ in thousands except per share amounts)

	1985	1986
Interest, Dividend and Fee Income		
Loans	\$5,786,891	\$5,692,852
Lease financing	48,857	46,490
Securities	921,652	868,165
Deposits with banks	1,099,279	921,979
	<u>7,856,679</u>	<u>7,529,486</u>
Interest Expense		
Deposits	5,700,915	5,263,337
Bank debentures	120,008	116,420
Liabilities other than deposits	70,620	68,685
	<u>5,891,543</u>	<u>5,448,442</u>
Net Interest Income	1,965,136	2,081,044
Provision for loan losses (note 12)	428,500	520,583
Net Interest Income After Provision for Loan Losses	1,536,636	1,560,461
Other operating income	682,002	818,856
Net Interest and Other Income	2,218,638	2,379,317
Non-Interest Expense		
Salaries	901,783	960,998
Pension and other staff benefits	94,768	98,581
Premises and equipment	364,821	390,504
Other expenses	426,053	485,402
	<u>1,787,425</u>	<u>1,935,485</u>
Income Before Provision for Income Taxes	431,213	443,832
Provision for income taxes (note 13)	87,646	86,500
Income Before Minority Interest	343,567	357,332
Minority interest	4,382	4,382
Net Income	\$ 339,185	\$ 352,950
Net income per common share (note 14)	\$3.75	\$3.70

*Bank of Montreal**Consolidated Statement of Appropriations for Contingencies*

For the Year Ended October 31

(\$ in thousands)

	1985	1986
Balance at Beginning of Year		
Tax allowable	\$155,143	\$390,337
Tax paid	169,796	66,764
	324,939	457,101
Changes During Year		
Loan loss experience for the year (note 12)	(329,680)	(604,682)
Provision for loan losses based on		
five-year average loan loss experience	428,500	520,583
Tax effect on subsidiaries' portion of loan loss		
experience less provision for loan losses	8,742	6,462
Transfer from retained earnings	24,600	80,000
	132,162	2,363
Balance at End of Year		
Tax allowable	390,337	317,620
Tax paid	66,764	141,844
	\$457,101	\$459,464

Bank of Montreal

Consolidated Statement of Changes in Shareholders' Equity

For the Year Ended October 31

(\$ in thousands)

Class A Preferred Shares (note 11)	1985	1986
Balance at beginning and end of year	\$ 650,079	\$ 650,079

Common Shares and Contributed Surplus (note 11)	Number of Shares	Common Shares	Contributed Surplus
Balance at October 31, 1984	70,497,599	\$ 140,995	\$ 807,982
Shareholder dividend reinvestment and share purchase plan	6,255,200	53,254	109,706
Stock dividend program	374,199	4,984	4,453
Exercise of Class A Preferred Shares — Series 2 Warrants	298,771	8,809	3
Transfer from Contributed Surplus to Common Shares	—	922,144	(922,144)
Balance at October 31, 1985	77,425,769	1,130,186	—
Shareholder dividend reinvestment and share purchase plan	3,596,274	115,015	—
Stock dividend program	239,977	7,194	—
Exercise of Class A Preferred Shares — Series 2 Warrants	2,620	86	—
Conversion of Bank of Montreal Mortgage Corporation Exchangeable Debentures	26	1	—
Balance at October 31, 1986	81,264,666	\$1,252,482	\$ —

Retained Earnings	1985	1986
Balance at beginning of year	\$1,021,610	\$1,215,111
Net income	339,185	352,950
Dividends — Common shares	(149,126)	(157,605)
— Preferred shares	(57,404)	(57,404)
Unrealized gain on translation of net investment in foreign operations net of applicable tax	25,580	9,792
Transfer to appropriations for contingencies	(24,600)	(80,000)
Income taxes related to the above transfer	59,866	—
Balance at end of year	\$1,215,111	\$1,282,844

Significant Accounting Policies and Practices

The accounting policies and financial statement formats of Canadian banks are prescribed by the Bank Act and its regulations. The accounting policies followed by the Bank conform in all material respects with accounting principles generally accepted in Canada, except for the accounting for losses on loans, the treatment of gains and losses on the disposal of certain debt securities and the translation of foreign currencies.

The significant accounting policies followed by the Bank are described below:

Basis of Consolidation

These consolidated financial statements include the Bank and all its subsidiary corporations. The purchase method is used to account for all acquisitions. The difference between the cost of the investment and the fair value of the net assets acquired is deferred and amortized over a period not exceeding 40 years.

Investments in affiliated corporations in which the Bank owns 20% to 50% of voting shares are accounted for by the equity method, whereby the income of such corporations is recognized based on the Bank's proportionate share of the earnings.

Translation of Foreign Currencies

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end exchange rates. Revenues and expenses are translated at the average exchange rates prevailing during the year.

Realized and unrealized gains and losses on foreign currency assets and liabilities, other than those relating to net investments in foreign operations, are recorded in Other Operating Income.

Unrealized foreign currency translation gains and losses on investments in foreign branches, subsidiaries and associated corporations are recorded in retained earnings net of any offsetting losses and gains after providing for applicable income taxes on liabilities and foreign exchange contracts used to hedge the investments. Such gains and losses are recorded in income only when realized.

Securities

The Bank's securities are accounted for on either a trading or investment basis.

Trading account securities are carried at market value, and gains and losses on sale and adjustments to market value are included in income.

Investment account securities are accounted for as follows:

Equity securities are carried at cost, and gains and losses on sales are included in income when realized.

Debt securities are carried at amortized cost. Gains and losses on sale of debt securities are deferred and amortized to income over five years, except for gains and losses on the sale of Treasury bills and similar instruments which are included in income when realized.

Any permanent impairment in the value of investment securities is recognized through a charge to income in the year of impairment.

Liquid securities are accounted for on an investment basis.

Securities which are loan substitutes are accorded the accounting treatment applicable to loans.

Loans

Loans are stated net of any unearned income, unamortized discounts and reservations for losses.

Loan fees are recorded in income when received to the extent that they relate to expenses which have been incurred or services which have been provided by the Bank. Fees received for loan rescheduling and fees received in lieu of interest are deferred

and amortized over the term of the loan.

Interest income is recorded on an accrual basis except on loans classified as non-accrual.

The accounting treatment for non-accrual loans, which complies in all respects with the regulations of the Inspector General of Banks, is as follows:

Classification as non-accrual	Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
	Loans are classified as non-accrual when payments are contractually past due six months.	Loans are classified as non-accrual when: 1. in the opinion of management there is significant doubt as to the ultimate collectibility of principal, in which case a specific reservation is established against the loan, or 2. payment of interest or principal is contractually past due 90 days and there is reasonable doubt as to ultimate collectibility, or 3. payment of interest or principal is contractually past due 180 days, or 4. in the opinion of management it is considered prudent or desirable to cease accruing interest, irrespective of the status of interest or principal payments.	
Interest	Accrued and unpaid interest is deducted from current income when the loan is classified as non-accrual. Interest is not capitalized if a loan is non-accrual nor is it capitalized to prevent placing a loan on a non-accrual basis.		
Application of subsequent payments	Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
	Subsequent payments are applied first to interest, then to principal, unless directed otherwise by the borrower.	Subsequent payments are applied first to interest, then to principal, unless directed otherwise by the borrower.	Subsequent payments are recorded in income only if management has determined that the loans do not require reservations, otherwise they are recorded as a reduction of principal.

Establishment of reservation

Personal Plan and Credit Card Loans	Sovereign Risk Loans	All Other Loans
Credit card loans are reviewed at least quarterly and fully reserved when they are six months in arrears. Personal plan loans are reviewed quarterly and fully reserved when they are one year in arrears.	Loans are reviewed at least quarterly. If there is significant doubt as to the ultimate collectibility of principal, a specific reservation is established at a level sufficient to provide for the estimated impairment of loan principal. The Bank also maintains general reservations against sovereign risk loans. The purpose of these general reservations is to permit management to provide from time to time against possible loan losses, when in its judgment circumstances are such as to give rise to concern, even though events may not have occurred which would justify the classification of individual loans as non-accrual. General reservations are prudential in nature and may be established on an allocated or unallocated basis.	Loans are reviewed at least quarterly. If there is significant doubt as to the ultimate collectibility of principal, a specific reservation is established at a level sufficient to provide for the estimated impairment of loan principal.
Credit card and personal plan loans are written off when they are fully reserved.	Loans are written off after all reasonable restructuring/collection activities have taken place and the possibility of further recovery is considered to be remote.	

Write-offs

Loan Losses

Actual loan loss experience comprises net new reservations for the year less recoveries against loans previously written off.

The provision for loan losses charged to income is calculated using an averaging formula, prescribed by the Minister of Finance, designed to average the loss experience over a five year period.

The difference between the actual loan loss experience and the five year average provision for loan losses is recorded in the Appropriations for Contingencies account.

Appropriations for Contingencies

The Bank makes appropriations for contingencies with respect to possible unspecified future losses

through transfers from retained earnings. The maximum amount of the appropriations which is tax deductible is prescribed by the Minister of Finance.

Land, Buildings and Equipment

Land, buildings and equipment are stated at cost less an allowance for depreciation and amortization. Major Canadian properties are depreciated using the sinking fund method, while all other buildings and leasehold improvements are depreciated on a straight line basis over their estimated useful lives. Equipment is depreciated using the straight line method over its estimated useful life.

Notes to Consolidated Financial Statements

1 Securities As at October 31	1985		1986					
			Term to Maturity					
			Within	1 to	4 to	6 to	Over	No
			1	3	5	10	10	specific
(\$ in millions)	Total	Total	Year	Years	Years	Years	Years	maturity
Investment Account								
Liquid securities								
Government of Canada								
Treasury bills	\$ 4,774	\$ 4,005	\$4,005	\$ —	\$ —	\$ —	\$ —	\$ —
Provincial government securities	127	575	573	—	—	—	2	—
U.S. Government Treasury bills and bonds	1,760	2,171	2,015	153	2	1	—	—
Other debt securities	1,165	1,555	549	106	190	245	465	—
	<u>7,826</u>	<u>8,306</u>						
Loan substitutes								
Term preferred shares	1,041	968	156	363	193	212	44	—
Floating rate income debentures	324	91	28	13	50	—	—	—
Fixed rate income debentures	79	74	—	74	—	—	—	—
Floating rate small business development bonds and small business bonds	288	205	123	50	32	—	—	—
	<u>1,732</u>	<u>1,338</u>						
Investment securities								
Government of Canada securities	—	21	—	6	—	15	—	—
Equity securities	186	134	—	—	—	—	—	134
Debt of foreign issuers	183	286	276	10	—	—	—	—
Other debt securities	10	3	—	1	2	—	—	—
	<u>379</u>	<u>444</u>						
Trading Account	587	437	264	47	32	81	13	—
	<u>\$10,524</u>	<u>\$10,525</u>	<u>\$7,989</u>	<u>\$823</u>	<u>\$501</u>	<u>\$554</u>	<u>\$524</u>	<u>\$134</u>

1985 data has been restated to conform with the 1986 presentation.

As at October 31, 1986 the current value of total securities is estimated to be \$10,554 million (1985 — \$10,541 million).

Securities of Harris Bankcorp, Inc. having a carrying value of \$843 million (1985 — \$654 million) were pledged, where permitted or required by law, to secure liabilities and public and trust deposits.

2 Non-Performing Loans

As at October 31

	1985			1986		
	(1) Domestic	International	Total	(1) Domestic	International	Total
(\$ in millions)						
Non-accrual loans	\$ 731	\$ 606	\$ 1,337	\$ 1,582	\$ 413	\$ 1,995
Re-negotiated reduced rate loans (2)	—	—	—	—	—	—
Total non-performing loans (net of applicable reservations) (3)	\$ 731	\$ 606	\$ 1,337	\$ 1,582	\$ 413	\$ 1,995
Breakdown of total non-performing loans:						
Non-accrual consumer loans	\$ 21	\$ —	\$ 21	\$ 15	\$ —	\$ 15
Other non-performing loans	710	606	1,316	1,567	413	1,980
Total non-performing loans (net of applicable reservations) (3)	\$ 731	\$ 606	\$ 1,337	\$ 1,582	\$ 413	\$ 1,995
Average Non-Performing Loans						
(net of applicable reservations) (3)	\$ 662	\$ 677	\$ 1,339	\$ 1,044	\$ 546	\$ 1,590

Interest Recorded as Income on Non-Performing Loans (4)

For the year ended October 31

(\$ in thousands)						
Interest Income (5)						
Non-accrual loans	\$18,333	\$107,631	\$125,964	\$35,594	\$84,889	\$120,483
Re-negotiated reduced rate loans	—	641	641	—	—	—
Interest income on non-performing loans	\$18,333	\$108,272	\$126,605	\$35,594	\$84,889	\$120,483

(1) The Domestic segment represents loans and interest booked in Canada regardless of currency or the residency of the customer. The International segment consists of loans and interest booked outside Canada, again regardless of currency or residency of the customer.

(2) Renegotiated reduced rate loans represent loans where, due to the weakened financial condition of the borrower, the rate of interest has been renegotiated to a rate less than the prevailing market. The financial information provided represents large

exposures only, that is, where the balance outstanding is in excess of 1/10 of 1% of the Bank's capital.

(3) Includes both specific and general reservations.

(4) Interest income on non-performing loans is reported net of previously accrued interest which has been reversed in the current reporting year. Gross interest income received was \$140,024 in 1986 (1985 — \$158,210).

(5) The yield net of interest reversals on net non-performing loans in 1986 was 7.6% (1985 — 9.5%).

3 Land, Buildings and Equipment

As at October 31

	1985	1986		
(\$ in thousands)	Net Book Value	Cost	Accumulated Depreciation	Net Book Value
Land	\$ 209,473	\$201,505	\$ —	\$ 201,505
Buildings	597,642	706,021	151,136	554,885
Equipment	265,587	680,459	373,415	307,044
Leasehold improvements	196,581			214,514
	\$1,269,283			\$1,277,948

Depreciation of buildings and equipment and amortization of leasehold improvements amounted to \$111,444 for the year ended October 31, 1986 (1985 — \$99,541).

4 Other Assets

As at October 31

	1985	1986
(\$ in thousands)		
Accrued interest income	\$ 750,308	\$ 661,396
Deferred income taxes	430,722	367,218
Goodwill and other valuation intangibles	159,973	138,910
Accounts and other receivables	158,549	268,875
Other	196,172	323,227
	\$1,695,724	\$1,759,626

5 Geographic Distribution of Assets by Location of Ultimate Risk

As at September 30, 1985

As at September 30, 1986

(currencies in millions)	Cdn. \$	U.S. \$	Other Currencies	Total Cdn. \$ Equiv.	Cdn. \$	U.S. \$	Other Currencies	Total Cdn. \$ Equiv.
Canada	38,265	4,370	87 £ 188 D.M. 51 S.F. 43 Cdn. \$ Equiv.	44,606	40,128	4,121	183 £ 103 D.M. 120 S.F. 32 Cdn. \$ Equiv.	46,415
United States	151	14,274	91 £ 61 D.M. 28 S.F. 24 Cdn. \$ Equiv.	20,013	300	16,892	73 £ 138 D.M. 43 S.F. 13 Cdn. \$ Equiv.	24,030
Europe								
United Kingdom	247	1,368	472 £ 145 D.M. 30 S.F. 38 Cdn. \$ Equiv.	3,162	254	1,083	423 £ 47 D.M. 55 S.F. 32 Cdn. \$ Equiv.	2,715
France	58	584	34 £ 73 D.M. 45 S.F. 37 Cdn. \$ Equiv.	1,027	127	580	22 £ 110 D.M. 45 S.F. 30 Cdn. \$ Equiv.	1,120
Germany	30	227	18 £ 504 D.M. 67 S.F. 2 Cdn. \$ Equiv.	678	41	448	2 £ 448 D.M. 28 S.F. — Cdn. \$ Equiv.	998
Other Europe	251	1,250	121 £ 453 D.M. 298 S.F. 263 Cdn. \$ Equiv.	2,882	277	1,311	78 £ 349 D.M. 395 S.F. 148 Cdn. \$ Equiv.	2,973
Latin America and Caribbean								
Brazil	211	952	— D.M. 2,739,659 Cruz. 9 Cdn. \$ Equiv.	2,010	211	875	4 D.M. 5,529 Cruz. — Cdn. \$ Equiv.	1,983
Mexico	326	1,073	— D.M.	1,801	324	1,070	1 D.M.	1,810
Other Latin America and Caribbean	89	1,093	3 £ 11 D.M. 64 Cdn. \$ Equiv.	1,666	98	1,026	— £ 7 D.M. 84 Cdn. \$ Equiv.	1,609

	As at September 30, 1985				As at September 30, 1986			
(currencies in millions)	Cdn. \$	U.S. \$	Other Currencies	Total Cdn. \$ Equiv.	Cdn. \$	U.S. \$	Other Currencies	Total Cdn. \$ Equiv.
Asia, Oceania and Australasia								
Japan	46	1,840	18 £ 202 D.M. 287 S.F. 475 Cdn. \$ Equiv.	3,367	81	2,036	8 £ 218 D.M. 343 S.F. 715 Cdn. \$ Equiv.	4,075
Other Asia, Oceania and Australasia	35	1,059	13 £ 34 D.M. 118 S.F. 280 Cdn. \$ Equiv.	1,886	41	987	19 £ 19 D.M. 141 S.F. 487 Cdn. \$ Equiv.	2,068
Africa and Middle East	1	171	2 £ 19 D.M. — S.F. 5 Cdn. \$ Equiv.	254	1	113	2 £ 9 D.M. 8 S.F. — Cdn. \$ Equiv.	174
Total Assets	\$39,710	\$28,261	859 £ 1,690 D.M. 924 S.F. 2,739,659 Cruz. 1,240 Cdn. \$ Equiv.	\$83,352	\$41,883	\$30,542	810 £ 1,453 D.M. 1,178 S.F. 5,529 Cruz. 1,541 Cdn. \$ Equiv.	\$89,970

Each of the countries noted separately above represent an ultimate risk of one percent or more of the Bank's aggregate outstanding securities, deposits with other banks, customers' liability under acceptances and loans excluding mortgages.

Assets are shown net of reservations in source currencies and Canadian dollar equivalents. Canadian dollar equivalents are also noted for sundry foreign currency outstandings.

Conversion Table September 30

	1985	1986
U.S. \$	1.3742	1.3876
Pound Sterling (£)	1.9149	2.0037
Deutsche Mark (D.M.)	.5119	.6852
Swiss Franc (S.F.)	.6251	.8437
Cruzado (Cruz.)	.00017562	.10019
(1985 — Cruzeiro)		
The Cruzado replaced the Cruzeiro at March 1, 1986.		
1 Cruzado = 1,000 Cruzeiros		

6 Deposits

As at October 31

	1985	1986
(\$ in thousands)		
Deposits by Canada	\$ 1,088,174	\$ 265,834
Deposits by provinces	109,552	154,229
Deposits by banks	18,918,410	18,533,194
Deposits by individuals	26,684,714	28,773,845
Other deposits	24,587,186	27,149,294
	\$71,388,036	\$74,876,396

7 Liabilities of Subsidiaries, Other than Deposits

As at October 31

(\$ in thousands)			Redeemable at the option of the subsidiary beginning	1985	1986
	Interest Rate	Date Maturing			
Bank of Montreal Mortgage Corporation					
Series A debentures	7.75%	October, 1987	October, 1977	\$ 1,297	\$ 1,195
Series B debentures	9.00	February, 1989	February, 1979	1,325	1,325
Exchangeable debentures (1)	11.75	September, 1991	October, 1986	95,657	95,656
Bank of Montreal Realty Inc.					
Series 1 debentures	13.625	December, 2000	—	100,000	93,000
Notes	16.75	March, 1988	—	75,000	75,000
Notes	10.75	November, 1992	—	—	75,000
Notes	9.50	May, 1996	—	—	100,000
Mortgages	(2)	(2)	—	6,842	9,185
Term debt	(2)	(2)	—	—	70
Bank of Montreal Leasing Corporation					
Series G notes, secured	10.50	February, 1986	—	15,600	—
Series I notes, secured	(3)	(3)	—	103,084	136,989
Short term notes, unsecured	(4)	(4)	—	166,357	150,200
Harris Bankcorp, Inc.					
Notes (5)	(2)	(2)	October, 1984	43,247	41,029
Empresa Técnica de Organização e Participações S.A.					
Mortgages	(2)	(2)	—	318	872
				\$608,727	\$779,521

(1) Exchangeable into common shares of the Bank as described in note 11.

(2) At varying rates of interest and varying terms to maturity to 1998.

(3) At varying rates of interest from 9.50% to 13.50% and varying terms to maturity to 1991.

(4) At varying rates of interest from 7.25% to 10.75% and varying terms to maturity.

(5) Denominated in U.S. \$.

The aggregate sinking fund requirements and maturities as at October 31, 1986 are as follows:

(\$ in thousands)	
1987	\$186,800
1988	123,833
1989	84,748
1990	22,459
1991	110,071
Thereafter	251,610
	\$779,521

8 Other Liabilities

As at October 31

	1985	1986
(\$ in thousands)		
Accrued interest payable	\$ 850,633	\$ 860,441
Accounts payable and accrued expenses	703,390	828,706
Deferred loan fees	33,242	38,980
	<u>\$1,587,265</u>	<u>\$1,728,127</u>

Included in Income from Loans is \$25,736 (1985 — \$20,287) of amortization of deferred loan fees.

9 Bank Debentures

As at October 31

(\$ in thousands)	Interest Rate	Date Maturing	Redeemable at the option of the Bank beginning	Denominated in U.S. \$	1985	1986
Series A	7.50%	April, 1992	April, 1986	—	\$ 2,842	\$ 2,842
Series C	7.25	February, 1987	February, 1983	—	966	966
Series 3	7.29*	April, 1989	April, 1984	—	75,000	75,000
Series 4	8.705*	August, 1991	August, 1984	—	125,000	125,000
Series 5 (1)	7.1875*	December, 1990	December, 1985	100,000	136,750	139,080
Series 6	6.1875*	October, 1991	October, 1988	125,000	170,938	173,850
Series 7	16.25	December, 1991	December, 1987	150,000	205,125	208,620
Series 8	15.25	July, 1994	—	30,000	41,025	41,724
Series 9	6.1875*	April, 1996	April, 1989	250,000	341,875	347,700
Series 10	6.6125*	July, 1998	July, 1991	250,000	—	347,700
					<u>\$1,099,521</u>	<u>\$1,462,482</u>

*Floating rate debentures: interest rate stated is as at October 31, 1986. Minimum rates of interest on the floating rate notes are as follows:
Series 3 — No minimum rate
Series 4 — 7%

Series 5 — 5.25%
Series 6 — 5.25%
Series 9 — 5%
Series 10 — 6.05%

All debentures are direct unsecured obligations of the Bank and are subordinated in right of payment to the claims of depositors and certain other creditors. In accordance with the formula prescribed in the Bank Act, the Bank has the capacity, as of November 1, 1986, to issue an additional \$131.2 million of debentures.

The aggregate sinking fund obligations and maturities of the Bank's debentures as at October 31, 1986 are as follows:

(\$ in thousands)	
1987	\$ 1,026
1988	118
1989	75,118
1990	118
1991	448,479
Thereafter	937,623
	<u>\$1,462,482</u>

(1) The Bank has given notice of its intention to redeem all of the outstanding Floating Rate Debentures, Series 5 on December 22, 1986.

If effected, the transaction would cause a reduction of \$139,080

in debentures maturing in 1991 with a corresponding increase in debentures maturing in 1987. Additionally, the Bank's debt issuing capacity would be increased to \$270.3 million of debentures.

10 Changes in Capital and Contingency Reserves

For the year ended October 31

The following table provides a summary of the increase in the Bank's Capital and Contingency Reserves.

	1985	1986
(\$ in thousands)		
Balance at beginning of year	\$2,945,605	\$3,452,477
Increases due to:		
Net income	339,185	352,950
Unrealized gain on translation of net investment in foreign operations net of applicable tax	25,580	9,792
Reduction of income taxes due to transfer from Retained Earnings to Appropriations for Contingencies	59,866	—
Excess (deficiency) of Provision for Loan Losses charged to income over Loan Loss Experience for the year	98,820	(84,099)
Tax effect on subsidiaries' portion of above excess (deficiency)	8,742	6,462
Shareholder dividend reinvestment and share purchase plan	162,960	115,015
Stock dividend program	9,437	7,194
Exercise of Class A Preferred Shares — Series 2 Warrants	8,812	86
Conversion of Bank of Montreal Mortgage Corporation Exchangeable Debentures	—	1
	3,659,007	3,859,878
Deduct:		
Dividends — Common shares	(149,126)	(157,605)
— Preferred shares	(57,404)	(57,404)
Balance at end of year	\$3,452,477	\$3,644,869

11 Share Capital

As at October 31

Authorized

200,000,000 Common Shares without par value. The aggregate consideration for all common shares shall not exceed \$5.5 billion.	12,500,000 Class B Preferred Shares without par value, issuable in series. The aggregate consideration for all Class B shares shall not exceed \$250 million. These shares may be issued in foreign currencies.
50,000,000 Class A Preferred Shares without par value, issuable in series. The aggregate consideration for all Class A shares shall not exceed \$1 billion.	

Outstanding (\$ in thousands)	1985		1986	
	Number of Shares	Amount	Number of Shares	Amount
\$2.85 Convertible Class A Preferred Shares Series 1 (1)				
Outstanding at end of year	5,799,400	\$ 200,079	5,799,400	\$ 200,079
\$2.50 Class A Preferred Shares Series 2; Convertible when tendered with Common Share Purchase Warrant (2)				
Outstanding at end of year	7,000,000	175,000	7,000,000	175,000
Class A Preferred Shares Series 3 (3)				
Outstanding at end of year	11,000,000	275,000	11,000,000	275,000
Common Shares				
Outstanding at beginning of year	70,497,599	948,977 (4)	77,425,769	1,130,186
Issued under the Shareholder Dividend Reinvestment and Share Purchase Plan and Stock Dividend Program	6,629,399	172,397	3,836,251	122,209
Issued on exercise of Common Stock Purchase Warrants	298,771	8,812	2,620	86
Conversion of Bank of Montreal Mortgage Corporation Exchangeable Debentures (5)	—	—	26	1
Outstanding at end of year	77,425,769	1,130,186	81,264,666	1,252,482
Total Outstanding Share Capital		\$1,780,265		\$1,902,561

(1) Annual cumulative dividend of \$2.85 per share. The Series 1 Convertible Preferred Shares are convertible at the option of the holder at any time before May 26, 1991 into common shares of the Bank at a conversion price of \$34.50 per common share. If the Bank's common shares have traded at a weighted average price at or in excess of \$36.60 for a period of 20 consecutive trading days, the Bank has the right to convert the convertible preferred shares into common shares at \$32.78 per common share before May 26, 1991. The convertible preferred shares are redeemable from May 26, 1986 to May 25, 1987 at \$36.23 per share, and thereafter at declining prices.

(2) Annual cumulative dividend of \$2.50 per share. Holders of the Series 2 Preferred Shares have received two common share purchase warrants entitling them to purchase one common share each at \$33.00 until December 15, 1988. Holders of the warrants have the option to exercise either warrant by delivering one Series 2 preferred share plus \$8.00 cash, equivalent to the difference between the exercise price and \$25.00. The Series 2 preferred shares are redeemable from December 16, 1988 to December 15, 1989 at \$25.75 per share, and thereafter at declining prices.

(3) Annual minimum cumulative dividend of \$2.125 per share. After February 23, 1989 each Series 3 Preferred Share is entitled to a minimum quarterly dividend equal to the greater of \$0.53125 per share or one quarter of 75% of the Bank's average prime rate (as defined) times \$25.00. The Series 3 preferred shares are redeemable from February 1, 1989 to January 31, 1990 at \$26.00 per share, and thereafter at declining prices.

(4) Includes \$922,144 of Contributed Surplus transferred to Common Shares on March 7, 1985.

(5) The holders of the \$95,656 exchangeable debentures (see note 7) of Bank of Montreal Mortgage Corporation due September 8, 1991 currently have the right to exchange the debentures for common shares of the Bank at a price of \$33.00 per common share. Since September 8, 1986, Bank of Montreal Mortgage Corporation has had the right to redeem the debentures at declining premiums, until maturity. If prior to September 8, 1991 the Bank's common shares have traded at a weighted average price at or in excess of \$34.65 for a period of 20 consecutive trading days, the Bank has the right to exchange the debentures for common shares of the Bank at \$31.35 per common share.

As at October 31, 1986, Common Shares were reserved for possible issuance in respect of the following:

	Number of Shares
Shareholder Dividend Reinvestment and Share Purchase Plan and Stock Dividend Program	3,923,501
Convertible Class A Preferred Shares Series 1	5,799,400
Exercise of Common Share Purchase Warrants attached to Class A Preferred Shares Series 2	13,697,109
Bank of Montreal Mortgage Corporation Exchangeable Debentures	3,315,324
	<u>26,735,334</u>

12 Loan Losses

For the year ended October 31
(\$ in thousands)

The provision for loan losses of \$520,583 (1985 — \$428,500) in the Consolidated Statement of Income is based on the five year averaging formula

prescribed by the Minister of Finance. Actual loan loss experience of \$604,682 (1985 — \$329,680) is charged to Appropriations for Contingencies.

13 **Income Taxes** For the year ended October 31

The Provision for Income Taxes recorded in the Consolidated Statement of Income represents taxes applicable to the income reported therein. The credit for Income Taxes recorded in Retained Earnings represents the income tax effect of gains

and losses on liabilities and forward exchange contracts used to hedge the investments in foreign branches, subsidiaries and associated corporations. These items are recorded directly in retained earnings.

	1985	1986
(\$ in thousands)		
Provision for Income Taxes		
Statement of Income		
Current	\$189,814	\$ 85,474
Deferred	(102,168)	1,026
	<u>\$ 87,646</u>	<u>\$ 86,500</u>
Statement of Retained Earnings		
Current	<u>\$ (83,329)</u>	<u>\$ (10,132)</u>
Deferred taxes result from timing differences in the recognition of revenue and expenses for tax and financial statement purposes. The sources of these differences and the tax effect of each were as follows:	1985	1986
Provision for loan losses	<u>\$(122,899)</u>	<u>\$(6,337)</u>
Other	<u>20,731</u>	<u>7,363</u>
	<u>\$(102,168)</u>	<u>\$ 1,026</u>

The Provision for Income Taxes recorded in the Consolidated Statement of Income is lower than the amounts that would be computed by applying the combined Canadian Federal and Provincial statutory income tax rate.

This is because a portion of interest and dividend income is exempt from tax or because income is taxed at other than the combined Canadian Federal and Provincial statutory income tax rate.

	1985	1986
Combined Canadian Federal and Provincial statutory income tax rate	48.1%	49.6%
Increase (Decrease) in rate resulting from:		
Tax-exempt income from Canadian securities, primarily income debentures, preferred shares and small business development bonds	(14.0)	(11.5)
Lower income tax rate applicable to income of foreign subsidiaries	(13.6)	(21.3)
Other	(0.2)	2.7
Effective income tax rate	20.3%	19.5%

14 Net Income per Common Share

For the year ended October 31

Net income per common share has been calculated using the daily average of common shares outstanding. For the year ended October 31, 1986 this average was 79,981,715 (1985 — 75,193,290). Fully diluted net income per common share was \$3.59 (1985 — \$3.64) and has been calculated as if: (a) all outstanding Class A Convertible Preferred Shares — Series 1 had been converted into common shares at the beginning of the year, (b) all outstanding

Class A Preferred Shares — Series 2 had been converted into common shares at the beginning of the year with the exercise of a Warrant, (c) all the remaining Series 2 Warrants had been exercised for common shares, and (d) assets at the current rate of leverage had been generated from the foregoing conversions, upon which earnings were imputed using the current rate of return on total assets.

15 Commitments and Contingencies

As at October 31

In the normal course of business, there are various outstanding commitments and contingent liabilities such as commitments to extend credit, foreign exchange contracts and financial futures contracts which properly are not reflected in the financial statements. These also include letters of

credit and guarantees, the amounts of which are disclosed below. In the opinion of management, there are no material commitments or contingencies which represent unusual risk and no material losses are anticipated as a result of these transactions.

	1985	1986
(\$ in thousands)		
Guarantees	\$1,557,774	\$1,571,296
Letters of credit	2,300,327	3,131,158
	<u>\$3,858,101</u>	<u>\$4,702,454</u>

16 Pension Funds

For the year ended October 31
(\$ in thousands)

The Pension Fund Society of Bank of Montreal is the Bank's principal pension plan in Canada, while a number of smaller plans provide pensions to executives and to other employees in other parts of the world. These plans are generally non-contributory, with the Bank responsible for contributions to adequately fund the plans. The Bank has established the Pension Advisory Committee of the Board of Directors to provide guidance and report on plan affairs to the Bank's Board of Directors.

In the Pension Fund Society of Bank of Montreal the Bank uses the accrued benefit actuarial method and best estimate assumptions in valuing pension obligations. Pension plan assets are valued

at market values. Based on the most recent actuarial valuations dated October 31, 1985, pension plan assets were \$638,517 and contractual pension plan obligations were \$498,200. Experience gains/losses and amounts arising as a result of changes in assumptions and plan initiation or amendments are amortized over the expected remaining service life of the employee group.

Total pension expense which was \$14,826 in 1986, (1985 — \$20,948) includes straight line amortization of experience gains/losses and amounts arising as a result of assumptions and plan changes, current service cost, interest revenue/expense on plan assets and pension obligations and Bank contributions to the Canada and Quebec Pension Plans.

17 Lease Commitments

As at October 31

Annual contractual rental commitments of more than \$25,000 on leased buildings and equipment are as follows:

(\$ in thousands)	Annual Commitments
1987	\$ 75,762
1988	68,304
1989	60,430
1990	53,045
1991	42,914
Thereafter	460,021

18 Legal Proceedings

As at October 31

Management considers that the aggregate liability which may result from various legal proceedings

outstanding against the Bank and its subsidiaries will not be material.

19 Domestic/International Segmented Financial Data

Domestic Operations represents the Bank's business booked in Canada as transacted in a variety of currencies regardless of the residency of the customer. International Operations represents business booked outside of Canada, again regardless of currency or residency of the customer. However, transactions on international money markets are deemed to be International even if booked in Canada.

In order to segment Domestic and International results, it is necessary to make certain allocations. The capital funds of the Bank are allocated based upon relative average assets. Any remaining excess or shortfall of assets in comparison with liabilities and capital funds is considered as supplied to or funded by the other segment at the marginal cost of funds. Corporate expenses are allocated based upon the relative amounts of non-interest expenses of each segment.

	Domestic		International		Total	
	1985	1986	1985	1986	1985	1986
(\$ in millions)						
Net interest income	\$ 1,190	\$ 1,220	\$ 775	\$ 861	\$ 1,965	\$ 2,081
Provision for loan losses	231	265	198	256	429	521
	959	955	577	605	1,536	1,560
Other income	431	503	251	316	682	819
	1,390	1,458	828	921	2,218	2,379
Non-interest expense	1,216	1,279	571	656	1,787	1,935
	174	179	257	265	431	444
Income taxes	24	38	64	49	88	87
	150	141	193	216	343	357
Minority interest	4	4	—	—	4	4
Net income	\$ 146	\$ 137	\$ 193	\$ 216	\$ 339	\$ 353
Average total assets	\$40,427	\$45,239	\$39,037	\$41,522	\$79,464	\$86,761
Return on average total assets	0.36%	0.30%	0.49%	0.52%	0.43%	0.41%

The only foreign country from which more than 10% of the Bank's consolidated interest income was derived was the United States, where interest

income was Cdn. \$1,671 in 1986 (1985 — Cdn. \$1,849).

Statement of Management's Responsibility for Financial Data

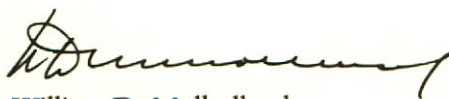
The consolidated statements of Bank of Montreal have been prepared by, and are the responsibility of, the Bank's management. The presentation and information provided therein have been prepared in accordance with the provisions of the Bank Act and related regulations and rules issued by the Inspector General of Banks, which correspond to generally accepted accounting principles except as noted within the annual financial statements. The financial statements necessarily include amounts based on informed judgements and estimates of the expected effects of current events and transactions with appropriate consideration to materiality. The financial information presented elsewhere in the Annual Report is consistent with that in the financial statements.

In meeting its responsibility for the reliability of financial data, management relies on comprehensive internal accounting, operating and system controls. The Bank's overall controls include an organizational structure providing for effective segregation of responsibilities, delegation of authority and personal accountability, written communication of policies and procedures of corporate conduct throughout the Bank, and careful selection and training of personnel; the regular updating and application of written accounting and administrative policies and procedures necessary to ensure adequate internal control over transactions, assets and records; as well as a continued program of extensive internal audit covering all aspects of the Bank's operations. These controls are designed to provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining

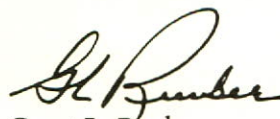
accountability for assets, and that assets are safeguarded against unauthorized use or disposition.

The Board of Directors oversees management's responsibilities for financial statements through the Audit Committee, which is composed solely of directors who are not officers or employees of the Bank.

The Shareholders' Auditors and the Bank's Chief Auditor have full and free access to the Audit Committee to discuss audit, financial reporting and related matters.



William D. Mulholland
Chairman and
Chief Executive Officer



Grant L. Reuber
President and
Chief Operating Officer



Keith O. Dorricott
Executive Vice-President and
Chief Financial Officer

November 25, 1986

To the Shareholders of Bank of Montreal

We have examined the consolidated statement of assets and liabilities of Bank of Montreal as at October 31, 1986 and the consolidated statements of income, appropriations for contingencies and changes in shareholders' equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of Bank of Montreal as at October 31, 1986 and the results of its operations for the year then ended in accordance with prescribed accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.
Peat, Marwick, Mitchell & Co.
Chartered Accountants

Touche Ross & Co.
Touche Ross & Co.
Chartered Accountants

Montreal, November 25, 1986

Capital Stock

At October 31, 1986, the Bank had four types of shares outstanding: Class A Convertible Preferred Shares Series 1, Class A Preferred Shares Series 2, Class A Preferred Shares Series 3, and common shares. The Class A Preferred Shares Series 1 pay cumulative preferred dividends at an annual rate of \$2.85 per share and are convertible at the option of the holder at any time prior to May 26, 1991 on a one-for-one basis (subject to adjustment for certain events). The Class A Preferred Shares Series 2 pay cumulative preferred dividends at an annual rate of \$2.50 per share. In relation to the issue of the Class A Preferred Shares Series 2, the Bank issued common share purchase warrants entitling the holders to purchase common shares at \$33.00 per share up to December 15, 1988. The Class A Preferred Shares Series 3 pay cumulative preferred dividends at an annual rate of \$2.125 until February 23, 1989, thereafter, the quarterly dividend shall be the greater of \$0.53125 per share or an amount determined by applying one quarter of 75% of the Bank's average Prime Rate for stated periods to \$25.

Listing of Stock

The common shares of the Bank are listed on the Montreal, Toronto, Winnipeg, Alberta and Vancouver stock exchanges in Canada and The Stock Exchange, London, England. The shares list under the following stock symbols on Canadian exchanges: "BMO" for the common stock, "BMOU" for the Convertible Class A Preferred Shares Series 1, "BMOX" for the Class A Preferred Shares Series 2, and "BMOC" for the Class A Preferred Shares Series 3.

Stock Prices

The following table sets forth the high and low closing sale prices on the Toronto Stock Exchange of the common shares of the Bank for the periods indicated:

Year	High	Low	Volume
1982	26.75	17.00	10,990,400
1983	33.625	24.75	12,373,774
1984	28.375	21.375	16,740,700
1985	31.50	23.25	21,758,400
1986 Jan-Oct 31	35.25	27.25	24,501,300

Transfer Agent and Registrar

The principal transfer agent for both the common and preferred shares of the Bank is The Royal Trust Company at its principal offices in Halifax, Montreal, Toronto, Winnipeg, Regina, Calgary and Vancouver. The Royal Trust Company also acts as registrar for these shares.

Dividends

Dividends paid on the common shares of the Bank over the past five years are shown in the following table:

	Year Ended Oct. 31				
	1982	1983	1984	1985	1986
Dividends paid per common share	\$1.95	\$1.96	\$1.96	\$1.96	\$1.96

Dividend Options

Shareholders of Bank of Montreal may choose from several dividend options including:

Shareholder Dividend Reinvestment
and Share Purchase Plan
Stock Dividend Program
Electronic Funds Transfer Service

Shareholder Dividend Reinvestment and Share Purchase Plan

The Shareholder Dividend Reinvestment and Share Purchase Plan provides a means for holders of record of common shares or Class A Preferred Shares Series 1, Series 2 or Series 3, resident in Canada, to reinvest cash dividends in new common shares of the Bank at a purchase price of 95% of the average market price, without the payment of any commissions or service charges. Shareholders may also purchase additional common shares of the Bank at 100% of the average market price by making optional cash payments of up to \$40,000 per annum, whether or not dividends on shares are being reinvested.

Stock Dividend Program

The Stock Dividend Program provides a means for holders of record of at least 100 common shares or 100 Class A Preferred Shares Series 1, Series 2 or Series 3 to acquire common shares of the Bank at 95% of the average market price by electing that dividends be paid by the issue of common shares of the Bank having a value substantially equivalent to the cash dividend otherwise payable.

Electronic Funds Transfer Service

Shareholders not wishing to participate in the Shareholder Dividend Reinvestment and Share Purchase Plan or the Stock Dividend Program may choose to have dividends deposited directly to an account in any financial institution which provides electronic funds transfer facilities.

Details of the dividend options and enrolment forms may be obtained by contacting The Royal Trust Company, Corporate Trust Division, 630 Dorchester Boulevard West, Montreal, Quebec H3B 1S6.

Restraints on Bank Shares Under the 1980 Bank Act

The Bank Act contains restrictions on the ownership of shares of the Bank. These restrictions limit ownership of shares by all non-residents to a maximum of 25% of any class of shares. These restrictions also do not allow any individual to own more than 10% of any class of shares and prohibit ownership of the Bank's shares by Canadian or foreign governments.

Distribution of Shareholders

The following table indicates the distribution of common shareholders by country of residence at October 31, 1986:

	Shareholders
Canada	98.2%
United States	0.8
Other	1.0
	100.0%

Copies of Annual Report

Additional copies of this Annual Report may be obtained by contacting the Bank's Public Affairs Department, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8, or to Public Affairs, 1 First Canadian Place, Toronto, Ontario M5X 1A1; or to the divisional headquarters nearest you.

For other shareholder information, please write to the Secretary of the Bank, Head Office, P.O. Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8.

Sir Peter B. Baxendell (United Kingdom)

Retired Managing Director of the Royal Dutch/Shell Group, retired Chairman of Shell U.K. and of Shell Canada Limited.

Viscount Etienne Davignon (Belgium)

Managing Director of the Société Générale de Belgique, former Vice-President of the Commission of the European Communities and President of the International Energy Agency.

Francis Gautier (France)

Vice-Chairman and Chief Executive Officer of the BSN Group of companies.

Sydney Gruson (United States)*

Retired Vice-Chairman of The New York Times.

John H. Hale (United Kingdom)

Director of Bank of Montreal and Pearson plc.; retired Managing Director of Pearson plc; former Executive Vice President of Alcan Aluminium.

Ichiro Hattori (Japan)

President of Seiko Instruments and Electronics Ltd. and Seiko Epson Corp.

Walther Leisler Kiep (Federal Republic of Germany)

Managing Partner of insurance and reinsurance brokers Gradmann & Holler; Director of Bank of Montreal; Chairman of the Atlantik-Brücke; former member of the Bundestag and currently Treasurer of the CDU.

Hon. Allan J. MacEachen, P.C. (Council Chairman)

Leader of the Opposition, Senate of Canada, and former Deputy Prime Minister, Secretary of State for External Affairs and Minister of Finance.

José E. Mindlin (Brazil)

Chairman, President and a founder of Metal Leve S.A.; member of the Advisory Board of Banco de Montreal Investimento S.A.

William D. Mulholland (ex-officio)

Chairman and Chief Executive Officer, Bank of Montreal.

Sir Eric James Neal (Australia)*

Managing Director of Boral Limited.

Hon. Charles H. Percy (United States)

President of Charles Percy & Associates, Inc., former United States Senator from Illinois and Chairman of the Senate Foreign Relations Committee.

Peter von Siemens (Federal Republic of Germany)

Vice-President, Siemens AG and Head of Business Administration for the Corporate Research and Technology Department.

Hon. Jesús Silva-Herzog (Mexico)

Former Secretary of Finance and Public Credit, United Mexican States.

Jack H. Warren (ex-officio)

Retired Vice-Chairman and Director of Bank of Montreal; Chairman, Bank of Montreal Bahamas Ltd.

*Member-elect

W.D. Mulholland,
LL.D. (1)
Chairman of the Board

Grant L. Reuber, O.C. (1)
President

William E. Bradford,
F.C.G.A. (1,5,6)
Deputy Chairman

Stanley M. Davison (4)
Vice-Chairman

Charles F. Baird,
LL.D. (1,2,5)
Toronto
Chairman and
Chief Executive Officer
Inco Limited

Ralph M. Barford (5)
Toronto
President
Valleydene Corporation
Limited

Peter J.G. Bentley,
O.C. (6)
Vancouver
Chairman and
Chief Executive Officer
Canfor Corporation

Claire P. Bertrand (4)
Montreal
Company Director

Robert A. Boyd, O.C. (3)
Montreal
Vice-President
Gendron Lefebvre Inc.

**The Hon. Sidney L.
Buckwold, LL.D. (1)**
Saskatoon
President
Buckwold's Ltd.

Fred S. Burbidge,
O.C. (1,2,5)
Montreal
Corporate Director

Pierre Cote, C.M. (1,2,3)
Quebec
Chairman of the Board
Celanese Canada Inc.

C. William Daniel,
O.C. (1,5)
Toronto
Corporate Director and
Consultant

Graham R. Dawson (4)
Vancouver
President
G.R. Dawson Holdings
Limited

Louis A. Desrochers,
Q.C. (1,2)
Edmonton
Partner
Messrs. McCuaig Desrochers

John H. Devlin (4)
Toronto
Company Director

Edmund B. Fitzgerald (3)
Toronto
Chairman and
Chief Executive Officer
Northern Telecom Limited

John F. Fraser (1)
Winnipeg
President and
Chief Executive Officer
Federal Industries Ltd.

Thomas M. Galt (5)
Toronto
Chairman and
Chief Executive Officer
Sun Life Assurance Company
of Canada

J. Peter Gordon, O.C. (1,2,5)
Toronto
Director
Stelco Inc.

John H. Hale
London, England
Director
Pearson plc

Donald S. Harvie, O.C. (6)
Calgary
Chairman
Devonian Foundation

Richard M. Ivey, Q.C. (3)
London, Ont.
Chairman
Allpak Limited

Betty Kennedy, O.C.,
LL.D. (1,4)
Toronto
Broadcast Journalist

Walther Leisler Kiep
Stuttgart, FRG
Managing General Partner
Gradmann & Holler

Merv Leitch, Q.C. (3)
Calgary
Partner
Macleod Dixon

**The Right Hon.
The Earl of Lindsay**
London, England
Member
House of Lords

J. Blair MacAulay (6)
Toronto
Partner
Fraser & Beatty

Ronald N. Mannix (6)
Calgary
Chairman
Manalta Coal Ltd.

Fred H. McNeil
Calgary
Chairman
Dome Canada Limited
Former Chairman and
Chief Executive Officer Bank
of Montreal

Jerry E.A. Nickerson (4)
North Sydney, N.S.
Chairman
H.B. Nickerson & Sons Ltd.

Lucien G. Rolland,
O.C. (3)
Montreal
Chairman and
Chief Executive Officer
Rolland inc.

William M. Sobey (4)
Stellarton, N.S.
Honorary Chairman
Sobeys Stores Limited

Mary Alice Stuart (6)
Toronto
Chairman and
Chief Executive Officer
CJRT-FM Inc.

James C. Thackray
Toronto
Director
Bell Canada

Lorne C. Webster (1,3)
Montreal
Chairman and
Chief Executive Officer
Prenor Group Ltd.

B. Kenneth West
Chicago
Chairman of the Board and
Chief Executive Officer
Harris Bankcorp, Inc.

**1
Member of the Executive
Committee**
W.D. Mulholland, Chairman

**2
Member of the
Management
Compensation
Sub-Committee of the
Executive Committee**
J.P. Gordon, Chairman

**3
Member of the Audit
Committee**
L.C. Webster, Chairman

**4
Member of the Donations
Committee**
B. Kennedy, Chairman

**5
Member of the Risk
Review Committee**
C.W. Daniel, Chairman

**6
Member of the Pension
Advisory Committee**
W.E. Bradford, Chairman

Executive Officers

W.D. Mulholland

*Chairman and
Chief Executive Officer*

G.L. Reuber

*President and
Chief Operating Officer*

W.E. Bradford

Deputy Chairman

S.M. Davison

Vice-Chairman

M.W. Barrett

*Executive Vice-President
Personal Banking*

W.B. Bateman

*Executive Vice-President
and Chairman,
Commercial Lending Committee*

J.S. Chisholm

*Executive Vice-President
and Treasurer*

K.O. Dorricott, F.C.A.

*Executive Vice-President
and Chief Financial Officer*

J.D. Gibson

Executive Vice-President

G.W. Hopkins

*Executive Vice-President
Electronic Data Processing
Systems*

D. Munford

*Executive Vice-President
Credit Policy*

G.E. Neal

*Executive Vice-President
Capital Markets*

K.E. Palmer

*Executive Vice-President
Commercial Banking*

M.R.P. Rayfield

*Executive Vice-President
Corporate and
Government Banking*

P. Bourgeau

Secretary

C. McGregor

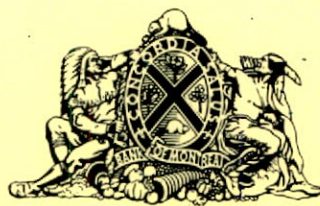
*Vice-President and
Chief Accountant*

S. Zargham, F.C.A. (U.K.)

*Vice-President and
Chief Auditor*

Legal deposit, 4th quarter (1986), Bibliothèque nationale du Québec.
 (On peut obtenir sur demande un exemplaire en français.)
 For copies of the Annual Report, please write to the Public Affairs Department of the Bank, P.O.
 Box 6002, Place d'Armes, Montreal, Quebec H2Y 3S8, or to Public Affairs,
 1 First Canadian Place, Toronto, Ontario M5X 1A1.
 For other shareholder information, write to the Secretary of the Bank, P.O. Box 6002,
 Place d'Armes, Montreal, Quebec H2Y 3S8.

Design: Montreal Creative Centre, Montreal
 Photography: All inside photos by John Harquail
 following exceptions:
 Australia: David Austen and
 Associates, Sydney
 Portrait of John Molson Sr.
 photos of John Molson Jr. and
 Herbert Molson: courtesy of
 Molson Breweries of Canada Limited
 Cover photo: Peter Christophers &
 Associates Limited, Toronto
 Colour
 Separations: Coloursgraph Reproduction Systems
 Inc., Toronto
 Typography: MCH Typography Ltd., Toronto
 Printing: Houghton Graphics Limited, Toronto
 Paper: Text and photo pages: Rolland inc., Montreal
 Cover: Provincial Papers, Thunder Bay



Bank of Montreal